TAXING SUBJECTIVE VALUE: FLOORS AS A RESPONSE TO HETEROGENEITY

Jason S. Oh[*]

This Article takes a fresh look at the problem of taxpayer heterogeneity—how the same good or service can have very different value depending on who receives it. This issue is well known in the fringe benefits context. Every tax student wrestles with Benaglia*, trying to figure out how much income someone receives from free room and board. But the problem goes far beyond fringe benefits. It also shows up when a parent loans money to a child, when luxury brands offer employee discounts, or when tech workers receive stock options. These examples come from separate corners of the tax literature, but they all point to the same underlying issue: income is hard to measure when value varies by taxpayer. Taxpayers vary not just in their consumption preferences, but also in their creditworthiness, likelihood to switch jobs, and other characteristics that affect the accurate measurement of income. This Article makes two main contributions. First, it identifies taxpayer heterogeneity as a cross-cutting problem that links many of tax law's toughest income measurement questions. Although each area has been studied separately, prior scholarship hasn't connected them through the common thread of heterogeneity. Recognizing that connection opens the door to broader insights and more unified solutions. Second, the Article explores a practical and intuitive way to deal with this problem: focusing on setting floor valuation using minimum benefits. Many goods or services provide at least a baseline value to any taxpayer. The tax code already hints at this approach in a few places but fails to make the floor explicit. This Article shows how building minimum benefit "floors" into the law can improve both the accuracy and the fairness of the income tax—while also making the rules simpler to administer.*

[*] Lowell Milken Professor of Law, UCLA School of Law. The author would like to thank Daniel Halperin and Eric Zolt for comments on previous drafts and would like to acknowledge the research assistance of Kelsee Luttgens and Jacob Gaynor.

INTRODUCTION 95
I. DEBT – USING FLOORS TO MEASURE HIDDEN INTEREST 97
A. Below-Market Loans 97
1. Employer-Employee Loans 97
2. Gift Loans 99
3. Shareholder-Corporation Loans 101
B. Original Issue Discount 101
C. Takeaways and Design Considerations 103
1. Is the Floor an Improvement over Doing Nothing? 103
2. Why a Floor Rather Than Some Other Threshold? 105
3. Should the Rule be Reapplied as Interest Rates Change? 108
II. FRINGE BENEFITS AND MIXED-MOTIVE BUSINESS EXPENSES 109
A. Four Examples. Four Approaches. 111
1. Benaglia – Primary Motive Test 111
2. Frequent Flyer Miles – Permissive 114
3. Employee Clothing – Strict 116
4. Qualified Employee Discount – Floor 119
B. How Could Floors Improve the Taxation of Fringe Benefits? 120
1. Benaglia – Free Room and Board 121
2. Food More Generally 122
3. Airline Miles 123
III. COMPENSATORY STOCK OPTIONS 124
A. Conceptual Problem 125
B. A Brief History of Option Taxation 127
C. Current Law 129
D. Floors in Option Taxation 131
1. In-the-Money Vested Options at Grant 131
2. Option With Readily Ascertainable Value Prior to Exercise 132
3. Section 83(b) and the Floor Approach 135
CONCLUSION 136

INTRODUCTION

An important and pervasive problem in taxation is accurately measuring income when the benefit received by a taxpayer depends significantly on their individual characteristics or preferences. In these situations, fair market value is often a poor measure. Take three examples—taxable fringe benefits, employer-employee mortgage loans, and compensatory options.

Chris and Fernanda are both professors in the political science department at UCLA. The housing market in Los Angeles is tight, with single-family homes out of the financial reach of most professors. Chris and Fernanda each receive a mortgage loan from UCLA at the same below-market interest rate. The interest rate reduction is income.[1] How much income depends on Chris and Fernanda's characteristics as a borrower. The baseline for measuring that income is the interest rate they would have been offered by a commercial lender.[2] Chris has a horrible credit history and very few assets, while Fernanda worked in investment banking before entering the academy and has a great credit score. The reduced interest rate provides Chris more income than Fernanda. Accurately measuring income depends on an important difference between taxpayers: their creditworthiness.

Mark and Ben are both managers at the same five-star resort on Waikiki Beach. They each receive a room at the hotel and unlimited food at the hotel restaurant. Mark loves living in a hotel and eating fancy restaurant food for every meal. Ben has much more modest taste and would prefer living in a studio apartment and home cook his meals. The free room and board are clearly income,[3] but how much should Mark and Ben be taxed on these benefits? Including the fair market value—the price paid by a customer who stayed 365 days in the hotel and ate every meal there—would wildly overstate the benefit to Ben and even Mark. Accurately measuring income hinges on how much consumption Mark and Ben enjoy. Free room and board have different value to different employees and depends on their idiosyncratic preferences.

Sharon and Tate both work as software engineers at a U.S. technology firm. They each receive stock options as part of their compensation. The stock options allow them to purchase company stock at a fixed price in the future but are forfeited if they do not remain employed at the company for two years from the grant of the

---

[1] The tax code defines income broadly and includes not just money, but benefits and services received in kind. I.R.C. § 61(a). In *Comm'r v. Glenshaw Glass*, the Supreme Court defined income as "accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." Comm'r v. Glenshaw Glass, 348 U.S. 426, 431 (1955). The interest rate reduction is a benefit that satisfies the *Glenshaw Glass* standard. *See id.* Chris and Fernanda are better off borrowing at a lower interest rate from UCLA than what is commercially available.

[2] The counterfactual can be even more complicated. What if Chris could not get a loan from a commercial lender on the terms offered by UCLA? For example, employer loans often allow for smaller down payments than commercial loans. Alternatively, what if Chris would have bought a smaller home but for the loan from UCLA? These complications make accurately measuring income even more difficult.

[3] Room and board and other in-kind benefits received from an employer meet the *Glenshaw Glass* standard. *See Glenshaw Glass*, 348 U.S. at 431. These benefits are taxable income unless excluded by statute.

option. Sharon is interested in building a long-term career at the company and has a family that she supports with her income. Tate has always been curious about working at start-ups, and she wants to live abroad at some point in the future. How much income should Sharon and Tate include at the time when the options are granted or when they vest? Again, the proper tax treatment depends on the taxpayer's preferences—the likelihood that they will satisfy the vesting requirement and the timing of option exercise. Compensatory options have different value to different employees.

The first contribution of this Article is to identify this cross-cutting problem in tax policy. No previous article has drawn the connection between the taxation of free room and board, employer-provided loans, and compensatory options. These literatures have previously been separate.[4] The core issue is that taxpayer heterogeneity makes measuring income difficult. Fair market value is not a good measure of income, and the benefit enjoyed varies based on the taxpayer's preferences or characteristics. These are hard fact patterns to tax appropriately, as evidenced by the overwhelming number of cases, statutes, and regulations trying different, often unsatisfactory, approaches.[5]

The second contribution of this Article is to highlight a relatively successful approach to dealing with fact patterns involving debt. Here, the Internal Revenue Code (the "Code") has used a *floor*—a minimum interest rate below which the Code assumes income. In the example of the employer-provided loan, if the interest rate that Chris and Fernanda borrow at is less than the rate at which the federal government borrows, then this difference is treated as income. The floor does not yield perfect outcomes, but measuring the specific benefits for Chris or Fernanda is impractical, as it relies on the creditworthiness of each taxpayer. Rather, the floor approach facilitates the taxation of a minimum amount of income in an administrable way.

One of the benefits of identifying taxpayer heterogeneity as a cross-cutting issue in taxation is that lessons can be drawn from successes in disparate areas of the law. The third contribution of this Article is to explore the implementation of floors in the other fact patterns. Successful approaches to the taxation of professors on their mortgage loans can be applied to hotel managers when they get free room and board or when a tech employee receives a compensatory option that she may or may not keep.

Return to the example of Mark and Ben, the hotel managers. Trying to estimate the actual benefit that each enjoys is impossible. Current law takes an all-or-nothing approach. If the room and board is "for the convenience of the employer," Mark and Ben include no income. If the "convenience of the employer" standard is not satisfied, Mark and Ben are taxed on the fair market value of the room and board.

---

[4] *See infra* notes 10, 25, 57, 113, and 122–23 summarizing the extant literature in each of these areas.

[5] Students who have taken an introductory class in federal income taxation will be familiar with many of the cases and statutes discussed in this Article.

What if instead, we established a floor—a minimum consumption value of the room and board for any person? This value could be estimated by looking at the avoided cost of meals and lodging. For example, each meal could be given a floor consumption value of $10. This rule would be administrable and result in a more accurate measurement of income. Similarly, with compensatory options, we could set a floor, the intrinsic value of the option when it vests and tax that minimum amount.[6]

Part I starts by exploring presumptive floors in the existing tax laws governing debt. Part II then considers the possibilities of using floors in the taxation of fringe-benefits. Floors have the potential to substantially improve the accuracy and fairness of taxation in this highly contested area of law in which Congress is constantly (and unsuccessfully) dabbling at the margins.[7] Part III considers the example of compensatory stock options. Taxing unvested options is particularly difficult—valuation is virtually impossible. Using a floor to tax options when they vest is administrable and reduces inappropriate and unfair deferral by highly compensated employees.

I. Debt – Using Floors to Measure Hidden Interest

The idea of using floors value may seem odd, but the law already does this in several contexts. This Part explores two different transactions involving debt where the tax code applies a floor to recharacterize principal as interest or interest rate reductions as compensation for services or gifts.

A. Below-Market Loans

The first set of examples involve below-market loans between related parties: from employers to employees, between family members, or from corporations to shareholders. Below-market loans are loans extended without interest or less interest than an unrelated party would charge. In each situation, the foregone interest disguises a transfer: compensation, a gift, or a dividend. These transactions enable tax avoidance and undermine the fairness and efficiency of the tax code.

1. Employer-Employee Loans

Chris is a superstar political science professor working at UCLA. His empirical research is heavily in demand across the country. In a bid to retain his superb teaching and research, UCLA extends Chris a loan at a 2% interest rate to purchase a home in Los Angeles despite his dodgy credit score. The market interest

---

[6] Options have both an intrinsic value (the difference between the current market price of the stock and the exercise price of the option) and a time value (the possibility that the stock price will increase before exercise). The intrinsic value is trivial to calculate for publicly traded stock and is a floor on the value of the option. *See infra* Section III.D.

[7] To give a sense of the struggle, Section 274 (which is just one of several statutes governing fringe benefits) has been amended twenty-four times, most recently in 2025. *See* I.R.C. § 274 (West, Westlaw through Pub. L. No. 119-21).

rate for borrowers of Chris's credit history, income, and assets is 7%. The 5% interest rate reduction benefits Chris and would ideally be taxed as income.

The stakes are significant if Chris can avoid tax on this economic benefit. Turning a blind eye to the transaction and treating the loan as if it were on market terms would allow Chris to enjoy substantial tax-free income. He would eagerly accept a lower cash salary in favor of the below-market loan. The employer is tax indifferent whether it is a private corporation or a non-profit and is happy to play along if it will lower the after-tax cost of compensating employees.[8] Not taxing this benefit would raise fairness issues and distort employee compensation. Employees whose employers refuse or cannot extend them loans would be taxed more heavily than Chris. Employers and employees would collude in structuring compensation to take advantage of the tax benefit.

Not taxing is problematic, but taxing this benefit raises its own challenges. How much of the rate reduction should be income? The accurate measurement of income depends on the individual characteristics of each borrower. Chris, who has a terrible credit score, receives a greater benefit than his colleague Fernanda, who has a great credit score and a willing cosigner. Fernanda could borrow in the marketplace at, say, 4%. Even though Chris and Fernanda receive the same mortgage loan at 2% from UCLA, they enjoy different amounts of economic income. Taxing Chris like Fernanda would undertax Chris. Taxing Fernanda like Chris would overtax Fernanda.

The tax law could try to figure out the exact amount by taking Chris's credit score and inferring a market interest rate. This would be difficult but not impossible. The specter of over or underestimating the amount of income included by Chris would still linger. Perhaps, Chris could have gotten a lower interest rate because he would have had a parent cosign the loan or a higher interest rate because of other debt that he had previously incurred. Accuracy is difficult.[9]

Section 7872 instead uses a floor.[10] The tax code assumes that no matter how good a credit risk Chris or Fernanda are, they cannot be more trustworthy

---

[8] Non-profits are indifferent because tax exempt entities are not taxed on interest income and do not benefit from deductions. *See Tax-Exempt Status of Universities and Colleges*, ASS'N AM. UNIV. (Oct. 2, 2022), https://www.aau.edu/key-issues/tax-exempt-status-universities-and-colleges [https://perma.cc/SQ2J-7EPK] ("Income from activities that are substantially related to the purpose of an institution's tax exemption, charitable contributions received, and investment income are not subject to federal income tax. The federal tax code classifies tax-exempt colleges and universities, and their foundations, as public charities."). Private employers, like corporations, forego a tax deduction for the compensation but also avoid offsetting interest income.

[9] There are other factors that reduce the amount properly included in Chris's income. First, it is possible that Chris would have purchased a more modest house but for the lower mortgage interest rate from UCLA. This is akin to the Benaglias probably not wanting to live in a hotel suite year-round if they were permitted to seek their own accommodations. Second, loans between employers and employees often have restrictive covenants that make them non-market. *See* Benaglia v. Comm'r, 36 B.T.A. 838 (1937), *acq.*, 1940-1 C.B. 1. For example, Chris's loan might require that he sell the house within sixty days if he leaves his UCLA employment.

[10] *See* I.R.C. § 7872(e)(1) (defining "below-market loan"). The extent literature discussing Section 7872 immediately follows its enactment in 1984. *See* Michael D. Hartigan, *From Dean and Crown to the Tax Reform Act of 1984: Taxation of Interest-Free Loans*, 60 NOTRE DAME L. REV. 31,

borrowers than the U.S. government.[11] If the employer loan charges interest at higher than the federal rate, there are no income tax consequences to the loan. However, if the loan charges interest at a rate lower than the federal government's, that difference must be included in income.[12] This forces employees to include some minimum amount of income for a reduced interest rate, but it saves the tax administrator from having to engage in the difficult problem of figuring out exactly how much the interest rate is properly treated as compensation income.[13]

Section 7872 technically also applies to the employer, but the tax consequences offset. Under Section 7872, the employer is deemed to receive interest income (to the extent that the interest rate is below the applicable federal rate) but is also deemed to pay that same amount as additional deductible compensation to the employee.[14]

2. *Gift Loans*

The same rule applies to "gift loans," loans in which "the forgoing of interest is in the nature of a gift."[15] For example, consider a parent lending money

---

32-42 (1984) (explaining the rule in light of the existing judicial precedents); Brien D. Ward, Comment, *The Taxation of Interest-Free Loans*, 61 TUL. L. REV. 849, 857-73 (1987) (same); Douglas A. Allison, Statute Note, *Taxation - Deficit Reduction Act of 1984 - Treatment of Loans with Below-Market Interest Rates (Section 172)*, 16 ST. MARY'S L.J. 745, 751-52 (1985) (explaining the legislative history of Section 7872 and the tax avoidance techniques it was intended to stop).

[11] The "applicable federal rates" are published monthly by the IRS. There is a short-term rate that applies to loans with a term of not more than three years, a mid-term rate for those with a term between three years and ten years, and a long-term rate for those loans with a term ten years or longer. *See, e.g.*, Rev. Rul. 2025-13, 2025-28 I.R.B. 11 (publishing applicable federal rates for July 2025). These rates are currently between 4% and 5%.

[12] *See* I.R.C. § 7872(e)(1) (defining "below-market loan"); I.R.C. § 7872(c)(1)(B) (applying Section 7872 to below-market loans between employers and employees).

[13] Interestingly, the amount of income included for a rate of interest below the applicable federal rate changes as the applicable federal rate changes. This is a curious result, and one could see the law taking the opposite approach. Consider a borrower who gets a 3% commercial mortgage loan when mortgage rates are 3%. If interest rates later move up to 6%, we do not include any amount in income even though the taxpayer is clearly better off. But the result changes for loans between employers and employees. *See* I.R.C. § 7872(c)(1)(B). Imagine that Chris borrowed from UCLA at 3% at a time when the applicable federal rate was also 3%. That year, he has no income for foregone interest. Next year though, the applicable federal rate goes up to 4%. He will have to include the 1% of foregone interest in income as if he had received it as compensation income. This is true even though there may have been no compensatory intent when the loan was made. This is the rule applied to all "demand loans," i.e., loans for which the lender can demand repayment at any time. As applied to loans repayable on demand, the rule is sound—the logic is that the lender could demand repayment and reloan the same amount at the applicable federal rate. However, this same rule is also applied to loans that are conditioned on future provision of substantial services. *See id.* The variable inclusion makes less sense in that context.

[14] *See* I.R.C. § 7872(a)(1).

[15] I.R.C. § 7872(f)(3). Prior to the enactment of Section 7872 in 1984, courts often found no income consequences from an interest-free gift loan. *See* Dean v. Comm'r, 35 T.C. 1083, 1090 (1961) (leading case on the income tax treatment of interest-free loans). However, interest-free loans were taxable under the gift tax. *See* Dickman v. Comm'r, 465 U.S. 330, 338 (1984); Marvin S. Lieber,

to a child at a zero interest rate. If not for Section 7872, such a below-market or zero-interest loan could be exploited to circumvent estate and gift taxes and avoid income tax on interest that would otherwise be earned by the lender parent.[16] Section 7872 reclassifies the foregone interest as a gift from the parent to the child for estate and gift tax purposes,[17] while also treating the same as an interest payment from the child to the parent for income tax purposes.[18]

But how much interest should be imputed?[19] The proper baseline is the rate of interest that the borrower would be charged in an arm's length transaction and would reflect the borrower's creditworthiness.[20] There is a larger hidden gift when a parent extends an interest-free loan to their unemployed son with significant credit card debt than when they extend the same interest-free loan to their other son who is gainfully employed and has significant assets. Accurately measuring the foregone interest is extremely difficult.

Section 7872 instead applies a floor. It uses the applicable federal rate to calculate the deemed gift and interest payment.[21]

Interest-Free Loans, 23 DUQ. L. REV. 1019, 1020 (1985) (tracing the history of judicial opinions dealing with interest-free loans).

[16] When Section 7872 was enacted, the legislative history specifically cited *Horst v. Comm'r* for the proposition that taxpayers are not permitted to assign income. *See* H.R. REP. NO. 98-432, pt. 2, at 1370 (1984).

[17] If the gift loan is a term loan, the difference between the loaned amount and the present value of the payments due under the loan is treated as a gift when the loan is made, but only for estate and gift tax purposes. *See* I.R.C. § 7872(e)(2). For example, a parent gives an interest-free loan to a child, to be repaid in ten years, and the applicable federal rate is 4%. Section 7872 would treat $324,436 as a gift for estate and gift tax purposes. If the gift loan is a demand loan, the yearly foregone interest is treated as a gift each year, accruing at the applicable federal rate.

[18] *See* I.R.C. § 7872(a)(1). The creditor will have interest income. *See* I.R.C. § 61(a)(4). The borrower may be entitled to an interest deduction depending on the use of the loan proceeds. *See* I.RC. § 163(a), (h) (providing in Section 163(h) that taxpayers cannot claim deductions for "personal interest" and defining that term).

[19] *See* Martin v. Comm'r, 649 F.2d 1133, 1134 (5th Cir. 1981) (prior to the enactment of Section 7872, noting that one challenge in imputing interest in interest free loans is deciding what rate should be used).

[20] Some contemporaneous commentators on Section 7872 attacked it for not taking into account the individual circumstances of the borrower. *See, e.g.*, Hartigan, *supra* note 10, at 64 ("[W]hat happens if the recipient of an interest-free demand loan does not invest the money loaned? . . . [T]he valuation method under section 7872 would lead to an unjust result."). Hartigan misses the point though. If the borrowers can derive different amounts of income (e.g., from lending the gifted amount), that difference will be captured by the tax law because they will recognize different amounts of income. Section 7872 simply standardizes the treatment of the gift loan itself. The use of the funds is irrelevant. Hartigan's proposal, however, still highlights a common problem when confronting tax issues involving heterogeneous taxpayers. There is a consistent impulse to achieve accuracy. Imagine a rule that changed in application depending on whether the below-market loan was invested in treasury bills or used to fund current consumption like a first-class trip around the world. Hartigan's proposal (or any proposal that looks to each taxpayer's individual characteristics) is unworkable.

[21] *See* I.R.C. § 7872(a)(1), (e)(2).

3. Shareholder-Corporation Loans

A similar rule applies to below-market loans from a corporation to a shareholder.[22] Under prior law, corporations and shareholders could collude to avoid dividend taxation by using interest-free loans.[23]

This situation is now subject to the same floor under Section 7872. If there is a below-market loan between a shareholder and a corporation, the difference between the stated interest rate and the applicable federal rate is treated as interest paid by the shareholder to the corporation. Simultaneously, there is a deemed distribution from the corporation to the shareholder. The income tax consequences for the shareholder may partially offset—dividend income and an interest deduction if allowed by Section 163. However, the corporation will have interest income and no matching deduction.[24]

B. Original Issue Discount

At the core of the taxation of employer loans is the principle that some interest rates are too low—interest rates that are too low hide compensation. The original issue discount ("OID") rules use the same principle to characterize certain payments of loan principal as interest.[25]

Sam the seller owns PurpleAcre and sells it to Bonnie the buyer for a note. The note provides for no annual interest payments and a lump sum payment of $2 million in ten years. In terms of economic substance, a portion of the $2 million represents interest—Bonnie needs to pay Sam more than the current fair market value of PurpleAcre because of the time value of money. This transaction is called a seller-financed purchase because Bonnie is effectively borrowing the purchase price from Sam.

If none of the $2 million purchase price is recharacterized as interest, it is a tax windfall for the seller. He has converted interest income into capital gain, and the capital gain can be deferred for ten years under the installment sale rules.[26] The problem is made even worse if the buyer takes the contrary position that a portion of the $2 million is interest and is deductible. This creates the possibility of two

---

[22] *See* I.R.C. § 7872(c)(1)(C).

[23] *See* Dean v. Comm'r, 35 T.C. 1083, 1090 (1961) (holding that shareholders could not be taxed on the imputed income from an interest-free loan).

[24] Dividends are generally not deductible for corporations. *See* I.R.C. § 162.

[25] There has been little scholarly interest in Section 1274 and the original issue discount rules. The extant literature on Section 1274 comprises of practitioners explaining the admittedly complex rules. *See, e.g.*, Courtney N. Stillman, *Choosing Interest Rates for Family Transactions to Avoid a Gift as well as Imputed Income*, 83 J. TAX'N 155, 155-56 (1995); Frank J. Slagle, *Accounting for Interest: An Analysis of Original Issue Discount in the Sale of Property*, 32 S.D. L. REV. 1, 30-31 (1987); Bartley F. Fisher & Stephen L. Norris, *The Ins and Outs of the New OID/Imputed Interest System as Applied to Sales of Real Estate: Is the Partnership an Alternative*, 63 TAXES 877, 878-79 (1985); *Report on the Proposed Original Issue Discount Regulations*, 40 TAX LAW. 481, 509 (1987); Richard J. O'Connor, *Measuring Discharge of Indebtedness Income from Debt Modification*, 70 TAXES 20, 23-26 (1992).

[26] *See* I.R.C. § 453(a)-(c) (gain is included as payments of principal are received).

different whipsaws for the government. The first is with respect to character; the seller takes the position that the full $2 million is purchase price, resulting in capital gain, while the buyer takes the position that a portion of the $2 million is deductible interest. The second whipsaw relates to timing. The seller defers gain recognition until year ten, while the (accrual-method) buyer deducts interest as it accrues.

To prevent these inconsistent positions, Congress implemented the original issue discount rules. The OID rules designate a certain portion of the debt as interest and then require buyer and seller to recognize interest at a constant rate.[27] These rules put both buyer and seller on the same schedule of recognizing interest.[28] But how much interest?

If there was a clear indication of PurpleAcre's fair market value, then we could infer the interest rate. For example, if we knew that PurpleAcre was worth $1.2 million when sold, we could infer that the remaining $800K was interest, and infer an interest rate of 5.24%.[29] Unfortunately, with property like real estate that is not publicly traded, we do not have a fair market value to infer an interest rate.[30]

Returning to our example, how much of the $2 million is interest? Figuring that out exactly raises familiar problems from our discussion of the employer loan. Could the buyer have borrowed from a commercial lender to finance the purchase? What interest rate would the commercial lender have charged? What is the buyer's creditworthiness? What other assets and liabilities does the buyer have? Is the note secured by PurpleAcre? Are there contractual limitations on the buyer's ability to further encumber PurpleAcre? Is the debt recourse or nonrecourse?

This is the same problem—the "proper" tax treatment depends on the individual characteristics of the borrower. In a hypothetical world in which we knew what the proper interest rate was, we could look at two sales for $2 million in ten years, OrangeAcre to Oscar and PurpleAcre to Pete, and determine that there was more interest (and correspondingly less purchase price) in the sale of OrangeAcre because Oscar is a much worse credit risk.

That is impossible to administer. Instead of giving up and assuming a 0% interest rate, Congress applies a floor to the interest rate—the rate at which the federal government borrows.[31] This interest rate is almost assuredly "wrong" in that no borrower, individual or corporate, can borrow at the same interest rate as the U.S. government. But using the federal interest rate is clearly an improvement in tax accuracy over assuming a 0% interest rate.

---

[27] *See* I.R.C. § 1272(a). There are exceptions from Section 1274 including exceptions for relatively small transactions (i.e., purchase price under $250,000) and the sales of personal residences. *See* I.R.C. § 1274(c)(3). However, even when Section 1274 does not apply, Section 483 prevents the conversion of capital gain into interest. *See* I.R.C. § 483(a). Under Section 483, the hidden interest is not taxed on an annual basis but rather when payment is received. *See id.*

[28] *See* I.R.C. §§ 1272-1274.

[29] Compounded annually at 5.24%, $1.2 million grows to $2 million over ten years.

[30] When the property sold is publicly traded, the original issue discount rules use the value of the property to infer an interest rate. *See* I.R.C. § 1272(a)(4) (defining the issue price of debt as the fair market value of the stock or securities where the property is publicly traded).

[31] *See* I.R.C. § 1274(b)(2)(B) (to find the sale price of the property, the Code discounts the payments due under the note to present value using the applicable federal rate).

Returning to the example, the current federal rate is roughly 4%.[32] Applying this interest rate assumption to the sale of PurpleAcre, the deemed purchase price is $1.35 million and the total amount of interest is $650K.[33] The $650K of interest will be reported as income by the seller over the ten-year period as it compounds at 4%. If deductible, the interest will be deducted on the same schedule.[34] The deemed purchase price of $1.35 million will be used to calculate the seller's gain on sale and the buyer's basis in PurpleAcre.

The floor also makes compliance simpler for taxpayers planning transactions. They can avoid the application of the original issue discount rules by simply having interest payable annually at a rate equal to or more than the federal rate.[35]

C. Takeaways and Design Considerations

1. Is the Floor an Improvement over Doing Nothing?

All four debt fact patterns involve second-guessing the "form" of a transaction. For the employer loan, the law looks through the loan's terms and infers that a reduced interest rate is hidden compensation. For the gift loan, the law looks through the loan's terms and finds a hidden gift. For the corporate loan, the law finds a disguised dividend. For the sale of PurpleAcre, the law recharacterizes some of the purchase price as interest.

The substance over form doctrine in tax law is a principle that emphasizes the actual economic reality of a transaction over its formal legal structure. This doctrine asserts that the tax implications of a transaction should reflect its true substance rather than merely its form or classification as defined by legal documents.[36] By focusing on the purpose and effect of transactions, the law aims to prevent taxpayers from gaining tax advantages through artificial arrangements that do not reflect genuine economic reality. Ultimately, this principle helps ensure

---

[32] The applicable federal rates are published by the IRS monthly. *See, e.g.*, Rev. Rul. 2025-10, 2025-19 I.R.B. 1421 (giving applicable federal rates for May 2025).

[33] Discounting $2 million at 4% for 10 years yields a present value of approximately $1.35 million.

[34] *See* I.R.C. § 163(e). The deductibility of interest depends on the use of the borrowed funds. *See* I.R.C. § 163(a), (h)(1)-(2).

[35] *See* I.R.C. § 1274(a)(1), (c)(2). If the debt instrument bears interest at least at the federal rate, the Code takes the note at face value. For example, if the applicable federal rate were 4% and Pete bought PurpleAcre for $2 million due in 10 years but with annual interest payments of at least 4%, the Code would accept the $2 million purported purchase price. But there are cases where the Court has applied a different floor for gift-tax purposes. *See,* Stillman, *supra* note 26, at 157-58. This issue arises because Section 7872 applies a floor equal to the applicable federal rate in the month that the sale occurs, while Section 1274 and Section 483 apply a floor equal to the lowest AFR in the three months ending in the month of the sale. This inconsistency should be resolved. There is no principled reason to favor either approach.

[36] *See* Gregory v. Helvering, 293 U.S. 465, 469 (1935) (holding that a transfer of stock to a newly formed corporation does not qualify as a reorganization under Section 112(g) because the new corporation "was brought into existence for no other purpose [than to reduce the petitioner's tax liability]").

that taxpayers pay their fair share based on the real nature of their dealings rather than on how those dealings are formalized.

The substance over form doctrine in its purest application would look through these transactions and recharacterize them using the actual interest rate appropriate to each employee or purchaser.

These floors can be understood as offering safe harbors for the application of the substance over form doctrine. If the employer charges interest at least at the federal rate, the Code will look no further for hidden compensation. If the seller of PurpleAcre charges interest at least at the federal rate, the tax law will accept the purported purchase price.

Do these rules improve on doing nothing? Almost assuredly, Section 7872 prevents employers and employees from colluding to reduce the tax burden of employees by hiding compensation as nontaxable interest rate reductions. The original issue discount rules prevent buyers and sellers from colluding to convert interest income into capital gain.

Identifying these rules as floors or safe harbors changes the types of questions we could ask of the rules' design. First, is the federal rate the right interest rate for the floor? In the original issue discount example, applying a higher floor than the federal funds rate would unfairly penalize AAA-rated corporate borrowers that can borrow at interest rates very close to the federal government.[37]

By contrast, in the employer loan example, it is hard to imagine any individual borrowing anywhere near the federal funds rate. A much more accurate floor might be the federal rate plus several percentage points. Historically, there has been a 1.5%-2% gap between the 10-year Treasury rate and 30-year mortgage rates.[38] Even the lowest risk borrowers face much higher interest rates than the federal government. Given that the premium between mortgage rates and treasury rates have varied dramatically, it might even make more sense for the IRS to publish a "minimum mortgage interest rate" each month based on the commercially available lowest interest rates on 10-, 15- and 30-year mortgages. This would improve the accuracy of the floor even more dramatically at very low administrative cost.[39]

But Section 7872 applies not just to mortgage loans, but many other below-market loans. Mortgage interest rates (since they are secured by real estate) tend to already be on the lower end of commercially available borrowing.[40] Thus, using

---

[37] *See Moody's Seasoned Aaa Corporate Bond Minus Federal Funds Rate*, FED. RSRV. BANK OF ST. LOUIS, https://fred.stlouisfed.org/series/AAAFF [https://perma.cc/H63C-FQCU] (last visited Feb. 10, 2026).

[38] *See* Grey Gordon, *Mortgage Spreads and the Yield Curve*, FED. RSRV. BANK OF RICHMOND (Aug. 2023), https://www.richmondfed.org/publications/research/economic_brief/2023/eb_23-27 [https://perma.cc/V64E-MK53] (noting that the gap between 30-year mortgage rates and 10-year Treasury rate was generally around 1.5-2% from 1990-2020 but has increased to 3% since 2020).

[39] The rules do not prevent employers from offering lower interest rates to their employees. It simply requires employees to include any discount below the interest rate floor as taxable compensation.

[40] Generally, home-equity lines of credit are available at lower interest rates than other sources of borrowing. The U.S. average home equity line of credit rate is currently around 7.3%. *See* Linda

mortgage rates as a floor on borrowing rates seems reasonable. Alternatively, different interest rate floors could be set for secured and unsecured borrowing. The floor for unsecured borrowing would be higher.

The purpose of this discussion is not to make a specific policy proposal, but rather to focus attention on the right question: what is the minimum floor off which we should measure income when an employee receives a loan from their employer or a child from a parent or a shareholder from a corporation? The appropriate floor might be several percentage points higher than the applicable federal rate.

What would be the effect of raising the floor on revenue? With employer-provided loans, raising the floor only has a tax consequence for the employee—the employee recognizes additional income and therefore revenue would increase. However, with gift loans, there are three potential tax consequences: the deemed interest affects the interest income reported by the lender, the gift for gift tax purposes, and possibly a deduction for the borrower.[41] Raising the interest rate floor (and imputing more interest) would increase gift tax revenue but would have a mixed effect on the income taxation of borrowers and lenders. Borrowers (e.g., children) would be taxed less, while lenders (e.g., parents) would be taxed more. The net effect on income tax revenue is probably positive.[42]

2. Why a Floor Rather Than Some Other Threshold?

Second, if the goal in measuring income is accuracy, why set a floor rather than use some other presumptive interest rate? Let's say in the PurpleAcre example, we used the average rate of interest on secured property loans, or in the employer example, we used the average rate of interest on residential home loans. By setting a floor, we are committing ourselves to making a mistake in only one direction. If we were equally concerned about mistakes in both directions, we could potentially improve overall accuracy by using some other interest rate as the baseline.[43] Take a simple example where there are two purchases for a lump sum of $2 million due in ten years: Oscar Corp. buys OrangeAcre and Pete Corp. buys PurpleAcre. Let's say that the applicable federal rate is 4%.

Assume that Oscar Corp. is creditworthy enough to borrow at 4%, so the OID rules recharacterize its purchase price as $912K and treat the remaining $1.088

Bell, *Current Home Equity Line of Credit (HELOC) Rates for February 2026*, BANKRATE, https://www.bankrate.com/home-equity/heloc-rates/?zipCode=10964 [https://perma.cc/N4M3-SKA8] (last visited Feb. 10, 2026). By contrast, the national average credit card interest rate is currently around 23.8%. *See* Matt Schulz, *Average Credit Card Interest Rate in US Today*, LENDINGTREE, https://www.lendingtree.com/credit-cards/study/average-credit-card-interest-rate-in-america/ [https://perma.cc/2E9X-FTNY] (last visited Feb. 9, 2026).

[41] *See* I.R.C. § 163(a), (h)(1)-(2).

[42] It is possible to avoid at least the initial application of Section 7872 by having interest equal to the applicable federal rate. *See* I.R.C. § 7872(a)(1) (section only applies to gift loans that are "below-market loans"); I.R.C. § 7872(e)(1) (defining "below-market loan" to include demand loans where the interest payable is less than the AFR). But Section 7872 could still apply if the applicable federal rate later rises. *See* discussion *infra* Section I.C.3.

[43] For example, if we wanted to minimize the sum of squared errors, we would use the average interest rate.

million as interest. That is accurate. The rules assume that there is 4% interest accruing each year and that reflects economic reality

But let's assume that Pete Corp. is less creditworthy and really should be borrowing at 6%, so its purchase price of $2 million hides even more interest. The Pete Corp. sale gets the exact same tax treatment as the Oscar Corp. sale. However, the accurate Pete Corp. sale price is $624K.[44] This allows the seller to convert an additional $288K from interest income into capital gain.[45] Under the current rules, there is no error with respect to the Oscar Corp. transaction but a substantial error with respect to the Pete Corp. transaction.

We could reduce the error of the Pete Corp. transaction while increasing the error of the Oscar Corp. transaction if we instead used 5% as the baseline rate. With this baseline, both the OrangeAcre and PurpleAcre transactions would be recharacterized as a $754K purchase price and $1.246M of interest. With the OrangeAcre transaction, this would be overestimating the amount of interest by $113K. This is obviously less accurate given that there was previously no error.

With the PurpleAcre transaction, however, the error is reduced—interest is only underestimated by $130K.

TABLE 1: THE IMPACT OF ERRORS

	Floor OID rules applied at 4%	**Alternative Baseline** OID rules applied at 5%
PurpleAcre Pete – low creditworthiness	Interest income underestimated by $288K	Interest income underestimated by $130K
OrangeAcre Oscar – high creditworthiness	Accurate	Interest income overestimated by $113K

Table 1 summarizes how the potential errors change under the floor and alternative baseline. The alternative baseline reduces the overall error (and the mean squared error) of the two transactions together. It would also have the benefit of raising revenue.

But there are reasons to perhaps prefer the floor approach. First, we may be asymmetrically concerned about over-taxing and under-taxing. If there is uncertainty as to the amount of reportable income, perhaps tax should only be due on amounts that can be proved to some standard. Under Section 7491, when a

[44] Discounting the $2 million at the appropriate discount rate of 6%, we find that the bona fide sale price of PurpleAcre is $624K.

[45] The rules assume that the interest component is $1.088 million for both transactions. The economic reality of the PurpleAcre transaction is that there is $1.376 million of interest.

taxpayer is in a dispute with the IRS, the burden of proof can shift to the IRS if certain requirements are met.[46]

For taxpayer morale, one can imagine that under and overinclusions are asymmetric.[47] Reducing underinclusions would generally expect to improve overall tax morale. Taxpayers see that the tax system is doing a better job of measuring income. The system is made fairer. However, even small *overinclusions* could dramatically reduce tax morale and perceptions of the tax system's fairness. There is a persistent idea in the U.S. that no one should overpay their taxes.[48] If this intuition is correct, then it is important that any adjustment to rules in this arena avoid the specter of overinclusion. Floors (properly calibrated) have this feature.

The second reason to use floors is the effect of non-floor rules on efficiency—and specifically on certain bona fide market transactions. In our example, the market interest rate for Oscar on the purchase of OrangeAcre was 4%. With a non-floor rule, we would effectively make it impossible for Oscar to be treated for tax purposes as borrowing at 4%. Recall that one way to avoid the OID rules is to have yearly interest payments at a rate equal to at least the applicable federal rate. If Oscar purchased OrangeAcre for its fair market value with stated interest payments of 4%, this transaction would reflect economic substance and have no tax avoidance purpose. Yet, with an applicable federal rate of 5%, the original issue discount rules would recharacterize the transaction and find additional interest.[49]

A similar issue would arise if the threshold mortgage interest rate were set too high for employer-provided loans. In that example, Chris would have been able to borrow at 7% and Fernanda would have been able to borrow at 4%, but they were both given 2% loans by UCLA. If the law uses a floor of 4%, Fernanda is properly taxed—she has 2% of hidden compensation in her reduced mortgage interest rate. Chris is undertaxed—he is only taxed on 2%, when in reality he is receiving 5% of compensation. Shifting the baseline up, for example to 4.5%, would reduce the undertaxation of Chris but overtax Fernanda. Setting a baseline higher than the floor creates the possibility of overtaxation, with the attendant risks and benefits explored above.

Using a threshold rate above the floor makes it impossible for employers and employees to engage in a transaction that reflects economic reality. With the floor interest rate set at 4%, Fernanda could borrow from UCLA at 4% without any

---

[46] The taxpayer must introduce "credible evidence" to support its position, comply with recordkeeping requirements, and cooperate with the IRS's requests for information. I.R.C. § 7491(a).

[47] Asymmetric treatment of over and underpayments exist throughout tax administration. For example, if a taxpayer overpays a tax liability, they can apply for refund from the government, but they do not get interest. In contrast, if a taxpayer underpays, they face interest and even penalties.

[48] Judge Learned Hand famously wrote, "Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes." Helvering v. Gregory, 69 F.2d 809, 810 (2d. Cir. 1934).

[49] If the purchase price of OrangeAcre were $912K with 4% stated interest over ten years, the original issue discount rules would recharacterize $107K as interest, or approximately an additional 1% of interest each year.

adverse tax consequences. The tax treatment reflects economic substance. That becomes impossible if the threshold interest rate is set at 4.5%. Fernanda could not borrow from her employer at 4% without adverse tax consequences. The tax law would tax her as if she was receiving additional taxable income.[50]

3. Should the Rule be Reapplied as Interest Rates Change?

Another important design question is when the interest rate floor should be applied. For OID sales, the floor is applied once when the transaction is entered into. If the transaction has sufficient cash interest when the sale is initially made, then the rules will not recharacterize the sale if interest rates subsequently increase. For example, if the applicable federal rate is 4%, and Oscar purchases PurpleAcre for $912K with 4% stated interest, the OID rules do not apply. If a year later, the applicable federal rate has increased to 6%, the OID rules are not reapplied.

The treatment of below-market loans is more complex—they are generally reevaluated semi-annually.[51] The hidden interest rules apply generally to "demand loans." A demand loan is any loan that is "payable in full at any time on the demand of the lender."[52] It reflects economic substance to reevaluate foregone interest on a demand loan periodically. If the lender could demand repayment but foregoes when prevailing interest rates are even lower, this forbearance serves as additional hidden interest.[53]

A similar logic applies to the ongoing reevaluation of hidden interest for gift loans.[54] The nature of the loan and the closeness of the relationship between borrower and lender exacerbates the potential for abuse. Imagine the alternative rule where any deemed interest is determined only at the loan's inception. Anytime that interest rates went down, the borrower (child) could "repay" the loan to the lender (parent) and then the lender could relend the amount back to the child, reducing the deemed interest. By cooperating, borrowers and lenders could ratchet down the bite of Section 7872. Where collusion between borrower and lender is more likely (and loans can easily be reissued), reevaluating the interest on an ongoing schedule prevents tax avoidance. This seems appropriate for loans to controlling shareholders by corporations and gift loans between family members.

However, it is less clear that employer-provided loans should be similarly reevaluated. The statute defines demand loans to include loans provided by an employer to an employee "if the benefits of the interest arrangements of such loan are not transferable and are conditioned on the future performance of substantial

---

[50] Somewhat mitigating this concern is the possibility of Fernanda simply seeking out a commercial loan at 4% if she is sufficiently creditworthy. This would bypass Section 7872 altogether.

[51] *See* I.R.C. § 7872(e)(1)(A) (foregone interest if the interest on a demand loan is lower than the applicable federal rate); I.R.C. § 7872(f)(2)(B) (using the short-term applicable federal rate semiannually).

[52] I.R.C. § 7872(f)(5).

[53] Contrast this semi-annual reevaluation from the treatment of "term loans" that are subject to Section 7872. The amount of hidden interest for term loans is determined at the inception of the loan and is not recalculated if prevailing interest rates change. *See* I.R.C. § 7872(f)(2)(A).

[54] *See* I.R.C. § 7872(a)(1), (e)(2).

services by an individual."[55] Section 7872 treats most employer-provided loans like demand loans and gift loans—interest is reevaluated based on changing federal interest rates. It is not clear that such treatment is warranted. Despite the employer-employee relationship, the employer cannot demand the repayment of the loan and reissue it at a higher interest rate if interest rates later move. The compensatory element of hidden interest is effectively locked in for the term of the loan when the loan is issued. For example, consider a loan between an employer and employee that is initially issued with no hidden interest—e.g., Fernanda is issued a 4% mortgage loan at a time when she could have gotten a 4% mortgage loan commercially. There is no hidden interest. If the applicable federal rate rises to 5% next year, Fernanda will be subject to tax on hidden interest. This does not seem like the right result if her loan is locked.

This rule perhaps reflects a discomfort with how low the floor is set—given that mortgage rates are usually significantly higher than the applicable federal rate, if an employer-provided loan has interest rates that even drift lower than the federal rate, that transaction is suspect. If that discomfort is the real reason, the better approach would be to set a more accurate floor on mortgage interest rates[56] and apply the rule only at the loan's inception.

II. FRINGE BENEFITS AND MIXED-MOTIVE BUSINESS EXPENSES

This Part focuses on how floors can rationalize two significant areas of tax law that have bedeviled Congress and the IRS for decades—fringe benefits and mixed motive business expenses.[57]

Fringe benefits encompass the many in-kind benefits that taxpayers receive from their employers. Hotel managers receive room and board on premises. Alphabet employees enjoy gourmet meals at the on-site cafeteria. An employee at Louis Vuitton purchases a $10K handbag at a 50% employee discount.

In each of these fact patterns, fair market value may not accurately reflect economic income. The hotel manager may be required to live on premises as a condition of their employment—the cost of a hotel room may accurately measure the consumption value enjoyed by hotel visitors, but overestimates the consumption enjoyed by the on-site hotel manager. Most Alphabet employees do not drive into

---

[55] I.R.C. § 7872(f)(5).

[56] *See* discussion *supra* Section I.C.1.

[57] The taxation of fringe benefits and mixed-motive expenses is one of the most fertile fields of tax academic writing. *See* Boris Bittker, *Income Tax Deductions, Credits, and Subsidies for Personal Expenditures*, 16 J. LAW & ECON. 193 (1973); Thomas D. Griffith, *Efficient Taxation of Mixed Personal and Business Expenses*, 41 UCLA L. REV. 1769 (1994); Joseph H. Guttentag et al., *Federal Income Taxation of Fringe Benefits: A Specific Proposal*, 6 NAT'L TAX J. 250 (1953); Daniel Halperin, *Business Deduction for Personal Living Expenses: A Uniform Approach to an Unsolved Problem*, 122 U. PA. L. REV. 859 (1974); Richard L. Kaplan & Dawson J. Price, *Change and the Continuity in Fringe Benefit Taxation: Seeking Sense and Sensibility*, 59 N.Y. L. SCH. L. REV. 281 (2014); John S. Nolan*, Taxation of Fringe Benefits*, 30 NAT'L TAX J. 359 (1977); Jay A. Soled & Kathleen Delaney Thomas, *Revisiting the Taxation of Fringe Benefits*, 91 WASH. L. REV. 761 (2016); Kate Stith, *Federal Income Taxation of Employee Fringe Benefits*, 89 HARV. L. REV. 1141 (1976).

the office on weekends simply to enjoy meals at the cafeteria. The Louis Vuitton employee may not have purchased the handbag at full retail price.

The fundamental issue lies in accurately measuring income, given the substantial diversity among taxpayers. Some hotel managers enjoy living at swanky hotels, and others hate it. Some Alphabet employees love eating at the cafeteria; others do not. The value that Louis Vuitton employees place on handbags varies dramatically.

Mixed motive expenses present a similar issue. Consider a scenario where a lawyer treats a client to an upscale dinner at Mastro's. It's clear that the cost of the client's meal qualifies as a deductible business expense; the lawyer does not gain any benefit from simply observing their client enjoy the dinner.

But what about the cost of the lawyer's meal? Should that also be deductible? What if the lawyer hates Mastro's and would never eat there but for the client's request? The business benefit is sufficient for them to pay $100 for a meal that tastes like ash. Alternatively, what if the taxpayer loves Mastro's and eats there every single day, dragging even unwilling clients there? The lawyer's enjoyment of the food is sufficient to eat at Mastro's. Any business benefit is additional. Most likely, the truth falls somewhere in the middle. The lawyer has mixed motives—there is both a business and a consumption benefit. Theoretically, the lawyer should only be allowed to deduct the cost of the meal above their consumption benefit.[58] But that is unknowable to the tax administrator and might even be difficult for the lawyer to divine.[59]

The same fundamental tax problem arises when a businessperson flies from Los Angeles to New York for business meetings but also catches up with a best friend from college on the same trip; a Los Angeles attorney drives down to meet a client in Orange County but stops to surf at Trestles on the way down. Mixed motive expenses are all around us.

The common threads between mixed motive expenses and fringe benefits are (1) that fair market value may not reflect the personal benefit to the taxpayer, and (2) taxpayer heterogeneity has a dramatic effect on accurate tax treatment. We do not have the same concern with cash compensation[60] or pure consumption expenses.[61]

---

[58] To accurately tax a meal that costs $50, we need to know its consumption value to the taxpayer. Say, the value is $20. If the employer provides the meal, the taxpayer should ideally include $20 as income. Conversely, if the taxpayer purchases the meal in a business-related context, the taxpayer should only be permitted a $30 deduction—the $50 cost of the meal less the $20 consumption that the taxpayer enjoyed. Halperin, *supra* note 58, at 863 ("[A] deduction should be permitted only to the extent that the costs incurred exceed the personal benefit obtained.").

[59] The hypothetical question is easily stated. How much would the lawyer be willing to pay for the Mastro's meal? Answering the question (honestly) is difficult.

[60] Unlike free room and board, $500 cash is worth $500 to everyone.

[61] If Myu purchases a PlayStation 5 for $500, we assume that he derives a consumption value of at least $500. Otherwise, he wouldn't purchase it. Even with pure consumption expense, there is some heterogeneity. For example, Myu and Dave both purchased PlayStation 5s for $500, but Myu would have been willing to pay $1,000 while Dave would only have been willing to pay $600. The

The core inquiry remains unchanged: how much personal benefit does the taxpayer derive? When it comes to fringe benefits, that benefit represents the amount of income that should be taxed. In the case of mixed-motive business expenses, that benefit indicates the portion of the expense that should not be eligible for deduction. But assessing that benefit is impossible for the IRS and difficult for taxpayers. The IRS cannot peer into taxpayers' minds. Taxpayers could at least theoretically value the benefit. Taxpayers could be asked, "How much would you pay for the meal?" and then be directed to only deduct the difference. But the law never asks taxpayers to perform this exercise. At first blush, it might seem an absurd ask. Yet, the law frequently interrogates taxpayers' primary motivations.[62]

This Part presents several paradigmatic examples to see how the rules have developed in this area. Employer-provided lodging is taxed under an all-or-nothing approach based on the primary motivation of the employer; frequent flyer miles are not taxed at all; clothing is never deductible; employee discounts are taxed using a floor. It then explores how floors might improve the fairness, accuracy, and administrability of the tax system in these important and highly contested contexts.

A. Four Examples. Four Approaches.

1. *Benaglia – Primary Motive Test*

Benaglia may be the most famous fringe benefit tax case ever decided and is considered a casebook staple.[63] Mr. Benaglia is the on-site manager of the Royal Hawaiian Hotel in Waikiki Beach. As part of his job, Mr. Benaglia and his wife are provided a "suite of rooms" as well as meals at the hotel. The IRS wants to include in the Benaglias' income the fair market value of meals and lodging, priced at $7,845.[64] Adjusted for inflation, this would have increased the Benaglias' income by hundreds of thousands of dollars and substantially increased their tax liability.[65]

The arguments and counterarguments in this case are typical. In favor of income inclusion, the Benaglias clearly benefited from the room and board. The accommodations were indeed remarkable, as the Royal Hawaiian remains an iconic property on Waikiki Beach. Depending on the season, a suite of rooms costs thousands of dollars per night, while a typical meal at the hotel restaurant is $50 or

---

tax system does not attempt to tax Myu on the surplus consumption even though he is "better off" than Dave.

[62] For example, when taxpayers have a mixed motive business expense, the general rule is that the expense is deductible if the "primary purpose" of the expense is business. *See* Rudolph v. United States, 370 U.S. 269, 269-70 (1962) (applying a "principal purpose" test when an employer paid for an employee to travel to New York City for a company convention). If allowed, the deduction may be subject to the limitation on the deductibility of meal and entertainment expenses imposed by I.R.C. § 274.

[63] Benaglia v. Comm'r, 36 B.T.A. 838 (1937), *acq.*. 1940-1 C.B.1.

[64] *Id.* at 839.

[65] Adjusted for inflation, $7,845 in December 1934 (one of the two years of income at issue in *Benaglia*) is the equivalent of $189,716.69 in December 2025 dollars. *See id.*; *CPI Inflation Calculation*, BUREAU LAB. STAT., https://www.bls.gov/data/inflation_calculator.htm [https://perma.cc/9KVY-2TH8] (last visited Feb. 10, 2026).

more per person. On the other hand, the hotel required Mr. Benaglia to be on-site to perform his job. Families of the Benaglias' means typically do not live 365 days per year in a luxury hotel, eating fancy restaurant food. Thus, the crux: the employee benefitted from the room and board provided by the employer, but it seems doubtful that fair market value (i.e., the price charged by the hotel to patrons) accurately measures their benefit.

The Supreme Court articulated the "convenience of employer test." If the room and board were provided for the employer's convenience, the employee could exclude the room and board from income.[66] The "convenience of the employer" rule is an example of a popular approach to situations in which fair market value is not a good measure of benefit. If the primary motive is business, the income is excluded. If the primary motive is personal, the income is included.[67]

The motive test is highly subjective, and there are important (often overlooked) design questions with motive tests, especially in the employer-employee context. There are two motives that could be relevant. What was the employer's primary motive in providing the room and board? Was the primary motive to pay in-kind compensation to the employee? Was the primary motive instead a condition necessary for Benaglia to effectively perform his job? We could also consider the motive from the employee's perspective. Was the motive for accepting the free room and board primarily its consumption value? Or was the employee rather forced to accept the room and board to secure employment?

In *Benaglia*, the Supreme Court held that the employer's primary motive was determinative. If the room and board were provided "for the convenience of the employer," then the income should be excluded. As applied to the Benaglias, the court found that the room and board were provided for the convenience of the employer, and the income was properly excluded.[68]

But consider *Rudolph v. United States*. By selling a certain amount of insurance, Rudolph qualified to attend a company convention in New York City. He was permitted to bring his wife on the trip, which was entirely paid for by the insurance company. At the convention, there was one morning dedicated to a meeting and business lunch, but the Rudolphs were otherwise free to enjoy New York City as they chose.[69] The IRS assessed the fair market value of the trip to the Rudolphs as income. Rudolph argued that the cost of the trip should be an

---

[66] *Benaglia*, 36 B.T.A. at 840-41.

[67] For taxpayer outlays, if the primary motive is business, the deduction is allowed. If the primary motive is personal, the deduction is disallowed. *See id.* at 838.

[68] *Id.* at 840-41. Congress later enacted I.R.C. § 119, approving the "convenience of the employer" rule and adding some additional requirements.

[69] *Rudolph v. United States*, 370 U.S. 269, 271-72 (1962) (Harlan, J., concurring). Here we see the familiar challenge. Accurate taxation would vary depending on how enjoyable each insurance agent found visiting New York City. There were 150 agents who qualified for the trip, and one imagines that there was great variability in the personal benefit to each agent. Unsurprisingly, Rudolph emphasized that he was "an entrapped 'organization man,' required to attend such conventions, and that his future promotions depend on his presence." *Id.* at 277. One imagines if asked by the IRS, most of his coworkers would protest in a similar manner, even those who love New York City.

excludible business expense. In that case, Justice Harlan's concurrence focused on the *employee's* primary motive in taking the trip.[70]

The basic problem faced by the tax system in these fact patterns is that exclusion inevitably underestimates the benefit to the taxpayer, but fair market value often wildly overestimates the value to the taxpayer, who often will have limited choice. The taxpayer would make very different consumption choices if instead he was paid the fair market value in cash. The Benaglias enjoyed free food and avoided the cost of finding their own housing. And yet, the Benaglias would almost assuredly have not eaten every meal at the hotel restaurant and lived in a fancy hotel suite if given that amount of cash in lieu of free room and board. Similarly, even assuming the Rudolphs enjoyed the trip to New York City, it would be a great coincidence if New York City was their number one travel destination.

What is the appeal of a primary motive test? The rules in this area can be understood as attempts to figure out whether the benefit to the taxpayer is closer to zero or to fair market value. The convenience of the employer requirement probes whether the consumption value to the taxpayer is minimal or closer to fair market value. For example, the convenience of employer rule requires that any excludable lodging be on the employer's premises. This requirement suggests that the employee had limited choice, and it was much less likely to be the choice of the employee. Imagine a new employee who negotiates for the employer to pay the rent on a nice house that the employee themself chose. If the lodging results from the employee's choice, it seems much more likely that the consumption value approximates the fair market value of the housing.

Setting aside its subjectivity and the obvious administrative challenge, a primary motive test has a deeper conceptual flaw. Primary motive tests compare the business benefit and the personal benefit from an expense. This is the wrong inquiry. The focus should rather be on how the fair market value compares to personal benefit. Somewhat counterintuitively, the business benefit is only indirectly relevant to whether a business deduction should be allowed.

This can be demonstrated by a few examples using the $50 that a lawyer spends on her own lunch when taking out a client.

<u>Example 1:</u> Business benefit is $10. Personal Benefit is $40.

The accurate result would be to allow her a deduction of $10. The personal benefit is greater, so no deduction would be allowed under a motives test. The motives test prevents the taxpayer from taking a small deduction they should be entitled to, but this is more accurate than the alternative (allowing a $50 deduction).

<u>Example 2:</u> Business benefit is $40. Personal Benefit is $10.

The accurate result would be to allow her a deduction of $40. The business benefit is predominant, so a $50 deduction would be allowed under a motives test. The motives test allows the taxpayer a slightly too big deduction, but this is more accurate than the alternative (i.e., disallowing the deduction).

---

[70] *Id.* at 276.

The motives test does well in Examples 1 and 2 because the business and personal benefit together are close to the fair market value of the meal. In that limited circumstance, the primary motive test will yield an acceptably accurate tax result. But consider Example 3.

Example 3: Business benefit of $60. Personal Benefit of $50.

The accurate deduction here is $0 because the lawyer is paying $50 for a meal that gives her a personal benefit of $50. However, a primary motive test would allow her a deduction of $50 because the business benefit outweighs the personal benefit.

Again, the correct theoretical inquiry is how much personal benefit the taxpayer received from the outlay. A comparison to the business benefit (as in a primary motive test) is only indirectly relevant. This deep conceptual flaw in the primary motive test exists in conjunction with significant administrative challenges.

2. *Frequent Flyer Miles – Permissive*

Frequent flyer miles are valuable. They can be redeemed for flights and seat upgrades. But they can also be used to subscribe to periodicals, shop for Apple products, or purchase gift cards from Starbucks or Walmart.[71] Miles can be gifted to friends and family or even donated to select charities.[72]

When a person earns frequent flyer miles as part of the personal purchase of a flight, the tax law takes the position that the frequent flyer miles are a nontaxable rebate or refund.[73] The price of the flight is reduced by the value of the frequent flyer miles, and there are no tax consequences.

But when a person earns frequent flyer miles for their personal account due to business travel, it no longer makes sense to treat it as a rebate. The miles accrue to the employee, not the employer or client who paid for the flight. If an employee accumulates miles through business travel, that employee clearly has taxable income,[74] but taxing that income has proved challenging.

This is another example where accurate taxation is frustrated by significant taxpayer heterogeneity. When the miles are earned for business travel, we do not know how much benefit a taxpayer gets from airline miles. There are challenges in accurately assigning a value to airline miles. Some miles expire unused. For those employees, there is a legitimate argument that the miles have no benefit. Other employees who are savvy about using airline miles (especially those fliers whose

---

[71] *See, e.g.*, *Use United MileagePlus Miles*, UNITED AIRLINES, https://www.united.com/en/us/fly/mileageplus/use-miles.html [https://perma.cc/ER3G-P7ZK] (last visited Jan. 27, 2026).

[72] *Id.*

[73] *Cf.* Rev. Rul. 79-96, 1979-1 C.B. 13 (noting that rebates reduce the purchase price of an item and are not includable in gross income).

[74] The personal airline flight meets the *Glenshaw Glass* standard of an accession to wealth, clearly realized, over which the taxpayer has complete dominion. Comm'r v. Glenshaw Glass, 348 U.S. 426, 431 (1955).

extensive business travel results in privileged status with the airline) can enjoy substantial value by using miles to purchase tickets or seat upgrades.[75]

Some have suggested taxing frequent flyer miles *ex post* when they are redeemed for value rather than when the miles are awarded. This would arguably result in an accurate measurement of income. This approach faces its own challenges. For example, many employees will earn loyalty points with the same airline for business and personal flights. If they later redeem miles for a personal flight, should we attribute the redemption to the business miles, personal miles, or use some pro rata rule? The same ticket on the same flight can vary dramatically in price depending on the type of fare, the conditions placed on the ticket, and the day of purchase. Thus, measuring value even ex post is a nontrivial task.

The IRS has officially stated that it will not tax the personal use of airline miles accumulated through business travel without Congressional action.[76] The IRS has similarly thrown in the towel on the taxation of employer-provided cell phones and cellular plans.[77]

Congress has also enacted legislation exempting particular fringe benefits. For instance, airline employees and their immediate family members can fly standby on flights without having to report any income;[78] meals at employer-owned cafeterias are excluded if certain requirements are met.[79] On the deduction side, Congress specifically allows for meals on overnight business trips to be fully deducted despite the obvious personal benefit of eating.[80]

These examples share the key characteristics of fringe benefits and mixed benefit expenses that make measuring income difficult: (1) fair market value likely does not accurately reflect personal benefit, and (2) the personal benefit can vary significantly among different taxpayers. While it may seem administratively convenient to forgo taxing fringe benefits, giving up carries various negative implications for tax policy, including issues related to revenue, fairness, and efficiency. The nontaxation of these benefits leads to a reduction in federal tax revenue, though quantifying the exact loss is challenging. Additionally, not all

---

[75] There is a cottage industry of point-redeeming specialists who try to optimize the benefits that they receive from loyalty programs. For example, The Points Guy publishes a monthly estimate of the redemption value of credit card, airline, and hotel reward points. Brian Kelly, *What are points and miles worth? TPG's January 2026 monthly valuations*, THE POINTS GUY (Jan. 06, 2026), https://thepointsguy.com/loyalty-programs/monthly-valuations/ [https://perma.cc/FW8T-K3LB]. As a personal anecdote, when redeeming rewards points, I have never achieved the lofty valuations published in that guide. This is in part because I do not invest a lot of time in the endeavor, but also because my travel dates are often inflexible. Suffice to say that there is significant heterogeneity in people's ability to turn points into value.

[76] I.R.S Ann. 2002-18, 2002-10 I.R.B. 621 ("[Issues relate] to the timing and valuation of income inclusions and the basis for identifying personal use benefits attributable to business (or official) expenditures versus those attributable to personal expenditures.").

[77] I.R.S. Notice 2011-72, 2011-36 I.R.B. 407. Employer provision of cell phones has increased dramatically recently. Soled & Thomas, *supra* note 58, at 763 n.7.

[78] *See* I.R.C. § 132(a)(1), (h)(1)-(3).

[79] I.R.C. § 132(e)(2).

[80] *See* I.R.C. § 162(a)(2). These meals are deductible even if there is no other nexus to the business, i.e., no business is discussed, and no clients are present.

individuals have equal access to these exclusions and deductions; for instance, airline employees can exploit significant tax-free income from standby flights, but that benefit is unavailable for those working in other industries; most employers do not provide gourmet campus cafeterias like Alphabet.[81] Moreover, this leniency encourages both employers and employees to design compensation packages that exploit favorable tax treatment, resulting in a higher reliance on in-kind compensation and creating inefficiencies within the labor market.

3. *Employee Clothing – Strict*

In other situations, the tax law simply disallows a deduction or exclusion completely. Sandra Pevsner was an employee at Yves Saint Laurent.[82] Her job required her to purchase Yves Saint Laurent clothes,[83] and the taxpayer tried to deduct the cost of the clothes as an ordinary and necessary business expense.[84] Pevsner provided evidence at trial that she did not wear the expensive designer clothes except for work and that her lifestyle was otherwise simple.[85] However, she did admit on cross-examination at trial that the clothes were "nice."[86] This fact pattern raises a now-familiar set of issues. It is unlikely that fair market value accurately measures the benefit to the employee, and the benefit varies dramatically between employees.[87] Some employees, like Pevsner, do not receive much personal benefit, while other employees who love YSL clothes benefit substantially.

If it were possible to measure the personal benefit that each employee enjoyed from the clothes, the tax law could allow a deduction for any excess of the cost of the clothes over the benefit. That would be the accurate deduction.[88] However, that is administratively impossible.

The clothing deduction rule is close to a complete disallowance. In order to qualify for a deduction, the work clothes must satisfy a three-prong test: (1) the clothing must be of a type specifically required as a condition of employment, (2) the clothing cannot be adapted to general use as ordinary clothing, and (3) the employee cannot wear it as ordinary clothing.[89] Since YSL clothes are worn as

---

[81] Even if a conglomerate were to acquire an airline, it could not offer the benefit to employees who worked in another line of business. *See* I.R.C. § 132(b)(1) (providing that the benefit only applies to services "offered for sale to customers in the ordinary course of the line of business of the employer in which the employee is performing services").

[82] Pevsner v. Comm'r, 628 F.2d 467, 468 (5th Cir. 1980).

[83] *Id.* Pevsner purchased the clothes at an employee discount. Even though she was denied a deduction for the cost of the clothes, she was not required to include the employee discount in income. *See* discussion *infra* regarding "qualified employee discounts."

[84] *Pevsner*, 628 F.2d at 469.

[85] *Id.*

[86] *Id.*

[87] In this example, it may be more accurate to say that the cost of the clothes does not measure personal benefit since Pevsner purchased the clothes at an employee discount.

[88] *See supra* note 59 and accompanying text.

[89] *Pevsner*, 628 F.2d at 469.

ordinary clothing by other (albeit wealthier) people, Pevsner's deduction was denied. The strictness of this rule means that most clothing deductions are denied.[90]

Another example of outright denial is the treatment of business-related entertainment. Imagine a lawyer takes a client to a Lakers game.[91] Prior to the enactment of the Tax Cuts and Jobs Act, it was possible to deduct the cost of that ticket when taking clients.[92] Since 2017, these deductions are simply denied.[93]

The blanket denial approach has benefits and drawbacks. Denying a deduction or exclusion raises revenue. The drawbacks are that the tax system measures income less accurately, with the attendant impact on the fairness of the tax system. The effect on administrability depends on whether the rule denies a deduction or an exclusion.

	Employee Pays – Do we allow a deduction?	Employer Provides – Do we allow an exclusion?
Permissive Rule	**Allow a deduction**	Allow an exclusion
Strict Rule	Deny deduction	**Deny exclusion**

Up to this point, we have not differentiated between situations in which the employer provides something and situations in which the employee pays for the same thing. This is because both fact patterns raise the same issues we are concerned about: (1) fair market value doesn't measure benefit accurately, and (2) benefit varies significantly between taxpayers. Conceptually, it doesn't matter who's paying—the employee or the employer. The core theoretical hurdle to taxing accurately is measuring the benefit to the taxpayer.

But from an administrability perspective, it does matter whether the employee or the employer is paying. It is much easier to deny a deduction when the employee pays, but much easier to allow an exclusion when the employer pays. Blanket denial of a deduction means that the IRS will not have to administer a rule and decide whether the deduction is proper. Allowing an exclusion means that the IRS will not have to administer a rule and decide whether an income inclusion is required.

---

[90] *See id.* at 470-71. An example of clothing that would be allowed as a deduction would be a radiation suit purchased by a chemist.

[91] This has the familiar features: (1) the cost of the tickets may not reflect personal benefit to the lawyer—he may prefer a different type of entertainment with another company, and (2) taxpayer heterogeneity confounds accurate measurement of income.

[92] Prior law provided that business-related entertainment was only deductible if the taxpayer "establishes that the item was directly related to, or, in the case of an item directly preceding or following a substantial and bona fide business discussion (including business meetings at a convention or otherwise), that such item was associated with, the active conduct of the taxpayer's trade or business." I.R.C. § 274(a)(1)(A) (2014) (amended 2017).

[93] I.R.C. § 274(a)(1)(A); Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97 § 13304, Stat. 2054, 2124-26 (2017). A similar change was made in 1994 to completely disallow deductions for any social club dues (e.g., golf club membership dues). I.R.C. § 274(a)(3) (1994).

Despite the same underlying conceptual problem, administrability has encouraged the law to evolve quite asymmetrically. Excluding airline miles and denying a deduction for clothing expenses takes opposing views on the conceptual question—the benefit of airline miles is valued at zero, and the benefit of clothing is valued at cost. Yet, each rule is more easily administered than the alternative.

We see this same asymmetry reflected in the concept of "working condition fringe." If the meal is deductible as a business expense (when paid by the employee), it should be excludible from income (when paid by the employer). The working condition fringe rule reflects this basic connection.[94] "Working condition fringe[s]" are any fringe benefits that would be deductible by the employee if they paid for the benefit themselves.[95] These fringe benefits are excludible.

However, this rule is not as symmetric as it first appears. The working condition fringe rule only references whether the hypothetical expense would be deductible as an ordinary and necessary business expense.[96] The working condition fringe definition does not consider whether the hypothetical deduction would be disallowed by other rules limiting deductions, of which there are many. For example, an employee will not benefit from a deduction if they claim the standard deduction instead of itemizing. Many employee expenses that relate to trade or business are treated as miscellaneous itemized deductions, which are currently suspended.[97]

This creates the curious asymmetry that the same expense, if paid for by the employer, is excludible (as a working condition fringe) but is not deductible by the employee if they must pay for it themselves. We are in the administrability diagonal: allow exclusions, deny deductions.

For example, an elementary school provides stationery to its teachers to prepare lesson plans. The stationery is an ordinary and necessary business expense and thus is excludible by the teacher as a working condition fringe.[98] However, if the school does not provide stationery and teachers are required to purchase the stationery themselves, they do not get the benefit of the deduction.[99]

One explanation for this asymmetry is administrability. But is there an alternative rationale? Perhaps, a stronger inference can be drawn that an outlay is primarily related to business when an employer pays than when an employee makes

---

[94] I.R.C. § 132(d).

[95] *Id.*

[96] *Id.* ("[A]ny property or services provided to an employee of the employer to the extent that, if the employee paid for such property or services, such *payment would be allowable as a deduction under section 162 or 167*.") (emphasis added).

[97] *See* I.R.C. § 62(a)(1) (treating as below-the-line deductions any trade or business expenses for employees); I.R.C. § 67(b) (treating as miscellaneous deductions any trade or business expenses for employees); I.R.C. § 67(h) (indefinitely disallowing all miscellaneous deductions).

[98] I.R.C. § 162(a)(1); I.R.C. § 132(d).

[99] This is because of the miscellaneous itemized deduction suspension. Even if the suspension is lifted, the deduction is of limited value. Miscellaneous itemized deductions are only deductible to the extent they exceed a floor of 2% of the taxpayer's adjusted gross income. Moreover, miscellaneous itemized deductions reduce the teacher's taxable income only if they itemize deductions. *See* I.R.C. § 62(a), (b), (h).

the purchase. The tax code is enlisting the employer as tax administrator. The IRS trusts that the employer's profit-seeking motive will prevent employers from abusing the working condition fringe exclusion on behalf of their employees. There is no such countervailing pressure when employees purchase for themselves.

4. *Qualified Employee Discount – Floor*

An employee discount allows employees to buy goods or services at a price lower than what is available to customers.[100] Absent an exclusion rule, employee discounts are income—imagine a supermarket that allowed its employees to take groceries home at no cost. The *Glenshaw Glass* definition of income is met. The free groceries are an accession to wealth, clearly realized, over which the taxpayer has complete dominion.

When an employee purchases a good or service at less than fair market value, there is a personal benefit. That benefit may be equal to the discount. A Chanel employee spends $3,000 for a purse that retails for $5,000. The amount of income from the discount is simply the difference of $2,000 if the employee values the bag at least $5,000. But the benefit may be much less. For example, the employee might not want to buy the purse at retail and only be willing to buy it at the discounted price. The employee might feel pressure (or even be required) to purchase Chanel goods to better sell those goods to customers. Putting aside any compulsion, all we really know is that the Chanel employee values the purse at least at $3,000. Again, we are faced with a familiar set of issues: fair market value is a poor baseline to measure personal benefit and taxpayer heterogeneity confounds accurate measurement of income.

As in *Benaglia*, we could exclude or include the entire discount based on the employer or employee's primary motive. As with airline miles, we could simply give up and not tax employee discounts at all. As with sports tickets, we could tax the full discount using fair market value as a baseline.

Instead of any of these approaches, the tax code allows a taxpayer to exclude the income from "qualified employee discount[s]."[101] For goods, the employee is permitted to exclude an amount of income up to the "gross profit percentage"; employees are allowed to exclude the discount to the extent it does not exceed the profit margin for the employer.[102] For services, employees are allowed to exclude up to a 20% discount.[103] Any deeper discounts are included in income.

This is a floor, or at least a quasi-floor—a baseline off which income is being measured. There is a minimum assumed personal benefit from employer-provided goods and services. For services, the Code assumes that the benefit of a service is at least 80% of its market price; any discount below that floor is includible as income. For goods, the law provides that the personal benefit of a good is at least its cost to the employer; any discount below that floor is includible as income.

---

[100] I.R.C. § 132(c)(3).
[101] I.R.C. § 132(a)(2).
[102] I.R.C. § 132(c)(1)(A), (c)(2).
[103] I.R.C. § 132(c)(1)(B).

Having identified this exclusion as a floor, we can evaluate whether it estimates the minimum benefit accurately. With respect to goods, the floor seems sensible. The employer cannot give the employee such a deep discount that they are taking a loss on the sale. The rule implies that the purchasing employee must be getting at least as much benefit from a good as its cost of production.[104]

With respect to services, the baseline seems arbitrary. Why 20%? Do we anticipate that services have a minimum benefit of 80% of their retail price? If the goal were to set a floor, that value would vary depending on the service—the minimum value of an hour of criminal defense services is different from that of an hour of Pilates instruction. There is no reason to suspect that the minimum benefit and the retail price of services are related to each other across industries.[105]

A different approach (more consistent with the concept of a floor) would place a minimum value on an hour of legal services and then include income to the extent that an employee is paid less than that minimum value. Alternatively, the excludible baseline could be set differentially for different industries. Either approach would create considerable administrative difficulties. The current rule measuring income off a baseline of 80% of its cost can perhaps be understood as an administrable alternative to setting floors on services individually.

B. How Could Floors Improve the Taxation of Fringe Benefits?

The previous Section showed a variety of approaches to fringe benefits and mixed-motive business expenses. First, the treatment could depend on the taxpayer's primary motive. Second, the tax law could be permissive, allowing a full deduction (for mixed motive expenses) or conceding no taxable income (for fringe benefits). Third, the tax law could be strict, allowing no deduction (for expenses) or including fair market value in income (for fringe benefits). Finally, the tax law could apply a floor by measuring income off a baseline, the minimum benefit of the good or service. The core reasoning behind this last approach is that, irrespective of an individual's preferences, any good or service provided by an employer or a mixed business-personal expense confers some personal benefit. This Section explores how floors might be implemented in the prior examples.

---

[104] This means that the excludible benefit will vary across industries. In luxury companies (like Louis Vuitton), employee discounts are often 40-50%. Luxury goods have high markups and so these steep discounts are still excludible. Companies like Walmart or Best Buy have much thinner profit margins and offer smaller discounts of 10%.

[105] This rule creates disparities between different providers of the same service that charge different prices. Two law firms allow their employees to employ the firm's lawyers at a discounted cost of $100/hr. The two law firms, however, charge very different prices to clients. The first firm charges $1000, and the second firm charges only $120. Two paralegals who sought legal representation from their employers would face vastly different tax outcomes. An employee of the first firm would have to include $700 of income. An employee of the second firm would be able to exclude the entire discount.

1. Benaglia – Free Room and Board

It would be relatively straightforward to set floors for employer-provided food and lodging. For food, the baseline could be estimated as the minimum avoided cost of a meal. For housing, the baseline could be estimated as the minimum avoided rental cost of a similar-sized apartment. For example, the law could assume a $10 minimum inclusion for any employer-provided meal and a $1 per square foot per month inclusion for employer-provided housing.

The question is when to apply this floor. There are two possible approaches.

One option is to do away with the convenience of the employer test entirely and simply apply a floor valuation to any employer-provided food or lodging. This rule would be too generous and result in substantial inequity. This would allow employers and employees to collude to structure a substantial amount of compensation as tax-free. Employees could enjoy sumptuous meals and luxury apartments while only including a small fraction in income.

A better option would be to keep the existing convenience of the employer test but apply the floor when the convenience of the employer standard is met. Current law forces a choice between zero income and fair market value. When the convenience of the employer rule is applied, no income is included. There is a 100% change of underinclusion and a 0% chance of overinclusion. Compare that to a floor approach. If the minimum benefit is correctly set, there is still a 0% chance of overinclusion, but the underinclusion is reduced. The floor approach strictly dominates current law, even though no attempt is made at accuracy. The goal is not to perfectly measure each taxpayer's benefit. A floor may underestimate the benefit to the taxpayer—they may, in fact, love the meal or the employer-provided home may be their perfect abode.

The floor approach is also simple to apply to repeated fringe benefits. A law firm caters a meal for its employees who work past 7 PM. The total cost is $1,000. Some lawyers eat a little. Others eat a lot. Not every lawyer attends each dinner. Sometimes there is food left over. How much should each lawyer include in income? Accurately measuring the consumption of each employee is impossible. Should we track how much each employee eats? Should we just divide the cost of the meal among the lawyers who are present? How about the food that goes unconsumed? Current law capitulates, and none of the employees includes any income.[106]

The floor approach would simply track the number of employer-provided meals for each employee. Multiplying the number of meals by the $10 minimum assumed benefit yields the inclusion for each employee for the year. An employee who ate 50 dinners at work would include $500 in their income at the end of the year; an employee who ate 10 dinners would include $100. This easily administered

[106] This meal likely satisfies the "convenience of the employer" standard and is excludible under Section 119. I.R.C. § 119.

rule reduces the unfairness of excluding the meals completely.[107] Underinclusion is reduced without any risk of overinclusion.

This law change would also raise a modest amount of revenue. But for a hotel employee who is eating lunch for free every workday, the yearly inclusion would be $2,500. The inclusion for a 1,000 square foot apartment would be $1,000 of income per month, or $12,000 per year. These income inclusions are potentially significant when aggregated across the economy.

2. *Food More Generally*

There is already a special floor rule for meals at employer-owned eating facilities (like Alphabet's cafeteria).[108] The value of those meals is excludible if the eating facility is "located on or near the business premises of the employer" and "*revenue derived from such facility normally equals or exceeds the direct operating costs of such facility*."[109]

The second prong of this rule looks a lot like a floor. The rule effectively provides that a certain benefit (i.e., the average operating cost of the eating facility) *cannot* be excluded. If the cafeteria breaks even, then there is less risk that there is hidden compensation.[110] This rule could be adapted more generally to require that the nonexcludable benefit from these types of facilities is equal to the average operating cost. There would then be two ways forward for employers. First, they could require employees to pay enough to cover that minimum benefit (and thereby avoid any income inclusion). Alternatively, employees could simply include a fixed amount of income per meal if the meals are free.

Excluding cafeteria meals from income is certainly defensible from the perspective of tax administration *if* the only option were accurately measuring income. But switching to floors shifts the focus from including the *right* amount in income to including *something* in income. If an Alphabet employee eats 200 free lunches at the office, measuring the right amount of income is difficult. Imagine, instead, if every meal had a minimum presumed benefit. The inclusion for the employee at the end of the year would simply require tracking the number of meals consumed and multiplying. For example, if the IRS set the minimum benefit of a meal at $10, and the employee ate 200 meals at work, they would include $2,000

---

[107] Taxpayers who received free room and board are better off than similarly situated taxpayers who did not receive free room and board.

[108] I.R.C. § 132(e)(2). The code excludes "de minimis" fringe benefits. I.R.C. § 132(e). De minimis fringe benefits are those the "value of which is (after taking into account the frequency with which similar fringes are provided by the employer to the employer's employees) so small as to make accounting for it unreasonable or administratively impracticable." I.R.C. § 132(e)(1). The intuition is that some fringe benefits are so small that the administrative complexity of keeping track of the value of the fringe is not worth the potential revenue. The exclusion for employer-owned eating facilities is a specific example of a de minimis fringe.

[109] I.R.C. § 132(e)(2)(A)-(B) (emphasis added).

[110] This looks like the qualified employee discount rule, where the discount is excludible so long as the discount doesn't exceed the employer's profit margin. *See supra* notes 104-07 and accompanying text.

in income. In such a regime, avoiding the inclusion would be as simple as charging the employees $10 per meal.

As with the convenience of the employer test, the floor is not enough on its own. A floor that was applicable to any employer-provided food would be too easily abused. The first prong that the eating facility be located on or near the employer's business premise echoes the similar requirements in the convenience of the employer test.[111] Why this prong? This gets at the motive for the meal—is there the potential for mixed motives for the meal? Is it likely that the cost of the meal overstates its benefit to the employee?[112] In other words, is this a meal where fair market value is likely overtaxing the employee?

The employer cafeteria exclusion offers several interesting takeaways. First, it is possible to apply a floor-like rule to tax employer-provided food—the law already does so with employer cafeterias. We could easily apply it to catered law firm dinners and free meals for hotel managers. There is nothing special about cafeterias. Second, consistently applying floors across contexts simplifies tax administration. Congress or the IRS need only set a floor for meals once, and that value could be applied across different rules. The current patchwork of rules treats meals differently depending on whether they are related to entertainment, whether they fit within the convenience of the employer exclusion, or whether they are provided in a cafeteria. Applying floors more consistently would simplify this area of the law. Third, an alternative way to set floors is to look at the cost of supplying the good (as in qualified employee discounts) or the service (as with employer-provided cafeterias).

3. *Airline Miles*

Measuring the value of airline miles accurately *ex ante* is difficult because the value ultimately realized can vary dramatically. But measuring the value of airline miles *ex post* faces its own difficulty because of tracing issues and often dramatic changes in the retail price of flights.

Several scholars have proposed an alternative—to simply assign all airline miles a fixed value, e.g., one cent per mile.[113] The contribution of this Article is not to improve on these proposals,[114] but rather to note how the taxation of airline miles

---

[111] *See* I.R.C. §§ 119(a), 132(e)(2)(A).

[112] As with the convenience of the employer rule, it is important to pair the floor with a test that ensures that there is some mixed motive. Otherwise, the potential abuse of the exclusion becomes problematic.

[113] *See* Soled & Thomas, *supra* note 58, at 796-97; Larry Zelenak, *Up in the Air Over Taxing Frequent Flyer Benefits: The American, Canadian, and Australian Experiences*, 9 CAP. MKTS. L.J. 420 (2014); Dominic L. Daher, *The Proposed Federal Taxation of Frequent Flyer Miles Received From Employers: Good Tax Policy But Bad Politics*, 16 AKRON TAX J. 1, 18 (2001) (proposing to include frequent flier miles at 1 cent per mile); *cf.* Trevor H. Frye, *For Everything Else, There's Taxes: Why Credit Card Rewards Should Stop Being Priceless*, 66 B.C. LAW REV. 121, 167 n.216, 167-68 (2025) (proposing to tax credit card points at 1-2 cents per point).

[114] Previously cited scholarship has explored many technical aspects (like valuation, timing, and information reporting) of a proposal that are beyond the scope of this Article. *See, e.g.*, Soled &

fits into a now familiar paradigm—the difficulty of valuing a benefit that is heterogeneous amongst taxpayers.

Airline mile proposals can also be placed in a broader context. A possible solution is to use a floor to assign a fixed lower-bound value to miles. Such a floor would aid tax administration, increase the income tax base, and make the tax system fairer. Again, the goal is not to measure the value of airline miles accurately, but rather to include some amount of income from the receipt of miles.[115] Note that these proposals would only apply to miles earned from business travel. Miles from personal travel would continue to be nontaxable rebates.

Exactly what value to use as a presumed minimum benefit is beyond the scope of this paper. There are many websites out there that purport to place a value on miles and other loyalty points.[116] Given the great variety in the value derived from airline miles and loyalty points, it seems best to use a low conservative value (in keeping with the idea of this includible benefit being a "floor") so as to not punish those business travelers who fail to maximize their value.[117] Employees who do not plan to use the miles or points can simply opt out of earning them on business travel.

III. COMPENSATORY STOCK OPTIONS

The courts and Congress have long struggled with how to tax stock options awarded by employers to employees. There are two problems: (1) when to tax, and (2) what character to assign the income. With respect to timing, income could be included when the option is granted, when the option vests, when the employee exercises the option, or when the employee sells the stock acquired through the option. Since the realization requirement is met at each of these four moments, income could be taxed at any or all of them.[118]

With respect to character, the income should be capital gain, ordinary income, or some mix. Conceptually, the challenge is that options have both a

---

Thomas, *supra* note 59, at 791; Zelenak, *supra* note 115, at 4; Daher, *supra* note 115, at 17; Frye, *supra* note 115, at 156.

[115] For employees who get no consumption value from airline miles, can avoid the income tax exclusion by simply opting out of accruing airline miles on business travel.

[116] *See generally* Craig Joseph, Meghan Coyle & Claire Tsosie, *How Much Are Travel Points and Miles Worth in 2026?*, NERDWALLET (Mar. 2, 2026), https://www.nerdwallet.com/travel/learn/airline-miles-and-hotel-points-valuations [https://perma.cc/WX3V-AH7B]; Ben Smithson & Brian Kelly, *What are points and miles worth? TPG's March 2026 monthly valuations*, THE POINTS GUY (Mar. 2, 2026) https://thepointsguy.com/loyalty-programs/monthly-valuations/ [https://perma.cc/U4BS-FJQY].

[117] In a 2012 article, Banoff and Lipton explore a variety of different ways in which airline miles could be currently valued. Sheldon I. Banoff & Richard M. Lipton, *Taxing Your Miles Won't Bring Smiles: What Value is Reportable?*, 116 J. TAX'N 173, 174-75 (2012) (rejecting the "highest and best use" approach because it overstates value for most taxpayers).

[118] Cottage Savings Ass'n v. Comm'r, 499 U.S. 554, 565-66 (1991) (holding that the realization requirement is met if property is sold or disposed of for "materially different" property; the "materially different" standard is met if the properties "embody legally distinct entitlements").

compensatory dimension (rewarded for past or future services) and an investment dimension (the value of the option changes over time as share prices move).

Section A starts with an example to show how the challenge of taxing compensatory stock options raises the same core issue—taxpayer heterogeneity—as the examples in Parts I and II. Section B briefly summarizes the history of option taxation. Section C considers the myriad ways in which the Code currently tries to tax options. Section D explores how a floor might improve the taxation of compensatory options.

A. Conceptual Problem

Sharon works as a software engineer at Alphabet. At a time when Alphabet stock is trading at $800/share, she receives a call option to purchase 100 shares of Alphabet stock at a "strike price" of $600/share. The option can only be exercised if she remains employed at Alphabet for two years. If Sharon leaves Alphabet before that time, she forfeits the options. Sharon's coworker, Tate, receives the same compensatory subject to the same vesting requirement.

Valuing compensatory options is difficult. For large publicly traded companies like Alphabet, there can sometimes be robust trading markets in call options.[119] Even those without a public market can be valued reasonably well using option-pricing theory.[120] However, publicly traded call options are different from compensatory options in important ways. Compensatory options are almost always subject to some vesting requirement (e.g., the condition that Sharon or Tate must continue to work at Alphabet for two years to exercise the options). Because of the vesting requirement, compensatory options rarely find willing buyers (and most compensatory options are explicitly prohibited from being transferred prior to vesting and exercise). Because of the vesting requirement and limitations on disposition of stock, compensatory options are less valuable than a call option without such restrictions, even if the call option has the same exercise date and strike price.[121]

---

[119] *See, e.g.*, *Alphabet Inc. (GOOG)*, YAHOO FINANCE, https://finance.yahoo.com/quote/GOOG/options/ (last visited Feb. 3, 2026) (Alphabet options chain).

[120] Fischer Black, Myron Scholes, and Robert Merton won the Nobel Prize in economics for their work on option-pricing theory. *See* Press Release, Royal Swedish Acad. Sci., Press Release Announcing Winners of 1997 Nobel Prize in Economics (Oct. 14, 1997), https://www.nobelprize.org/prizes/economic-sciences/1997/press-release/ [https://perma.cc/NW3R-FTEG]. The price of an option generally depends on the price of the stock, the exercise price of the option, the volatility of the stock, the length of the option, and the discount rate. *See generally*, Fischer Black & Myron Scholes, *The Pricing of Options and Corporate Liabilities*, 81 J. POL. ECON 637, 683 (1973); Robert C. Merton, *Theory of Rational Option Pricing*, 4 BELL J. ECON. & MGMT. SCI. 141, 141, 143-44 (1973).

[121] The value of the publicly traded call option provides a *ceiling* for the value of the compensatory option. When there is uncertainty regarding income, taxing based on a floor seems preferrable to taxing based on a ceiling. To draw some parallels to examples we have seen in earlier sections, taxing compensatory options based on the value of the corresponding (unrestricted) publicly traded option would be akin to taxing the Benaglias on the price a customer would pay to live in a hotel suite and eat restaurant food for a year or taxing an employee on the highest and best

There is no accepted theory on how to value options subject to a risk of forfeiture. The problem is a familiar one—taxpayer heterogeneity. Like the value of free room and board at a hotel, compensatory options can have wildly different values for different taxpayers. There are a variety of (unobservable) reasons why Sharon may be more likely than Tate to stay at Alphabet for the two-year vesting period. Sharon may be more risk averse than Tate and prefer a stable income to exploring higher variance opportunities at start-ups. Sharon may enjoy the work at Alphabet more than Tate. Sharon may have family (e.g., a child going to college) or health circumstances (e.g., a medical condition that requires expensive ongoing care) that make it more likely that she will stay at Alphabet. Sharon may be a more conscientious employee and less likely to get fired before the vesting period ends.

Existing models that attempt to price compensatory options do so in two different ways. One approach is to use company-wide data to estimate employee attrition—what is the probability that an employee will leave before the vesting period ends—and early exercise of options. Using this data, it is possible to estimate an average value for a compensatory option.[122] But of course that value will be higher than the actual value to Tate and lower than the actual value to Sharon.

Models that try to incorporate taxpayer heterogeneity are much more complicated. These models do not take the rate of attrition as exogenously determined. Instead, they include factors that might influence an employee to leave earlier or stay through vesting. For example, one model includes how much an employee might be able to earn by leaving and finding another job and the volatility of pay at that alternative job.[123] These models have the conceptual advantage of including the decision to leave as an endogenous variable that varies across taxpayers (rather than an exogenously fixed level of attrition). But these models are incredibly complicated and completely unwieldy from the perspective of a tax administrator. The point of this brief discussion of modeling is to emphasize how taxpayer heterogeneity matters in the valuation of compensatory options, and that

---

hypothetical redemption of their frequent flyer miles. Perceptions of fairness among taxpayers are a critical component of the U.S. tax system, which depends on voluntary self-reporting. Both under-taxation and over-taxation can jeopardize the norm of honest self-reporting, but over-taxation may pose a greater risk. Under-taxation tends to erode taxpayer confidence when individuals notice that others are being under-taxed. However, under-taxation of others is often difficult to detect since tax returns are confidential and because those who are under-taxed are unlikely to flaunt such. *See* I.R.C. § 6103. Over-taxation is much more observable—both when it happens to the taxpayer and when it happens to others. In contrast to under-taxation, people have no reason to keep quiet when they feel overtaxed.

[122] *See* John Hull & Alan White, *How to Value Employee Stock Options*, 60 FIN. ANALYSTS J. 114, 114-16 (2004); John D. Finnerty, *Modifying the Black-Scholes-Merton Model to Calculate the Cost of Employee Stock Options*, 40 MANAGERIAL FIN. 2, 28 (2014). These models also assume a rate of early exercise of options. In contrast to market options which are never exercised early (they are instead sold if the option holder wants to dispose of them), employees exercise options early because they must be exercised while employed.

[123] *See* Thomas A. Rhee, *On Valuing Employee Stock Option Plans with the Requisite Service Period Requirement*, 11 J. ENTREPRENEURIAL FIN. 39, 42 (2006) (noting that an unvested compensatory option is a compound option, "an option on an option to stay with the job"). To value an unvested compensatory option, the model needs additional assumptions. For example, one model assumes the employee's alternative market wage and the volatility of that wage. *See id.*

this heterogeneity is hard to observe and even harder to incorporate into measures of value.

B. A Brief History of Option Taxation

Valuing compensatory options is hard. Unsurprisingly, the courts and Congress have struggled to come up with an appropriate taxing scheme.

Before the 1940s, both courts and the IRS sometimes acknowledged a "proprietary stock option." This type of option was granted to employees not as a form of compensation but to provide them with an interest in the company's future success. This differentiation permitted capital gains treatment on the difference between the exercise price and the fair market value, thereby circumventing ordinary income taxation. However, the legal precedents on this matter were inconsistent.[124] In 1938, the Board of Tax Appeals affirmed this distinction in *Geeseman v. Commissioner*,[125] ruling that options meant to confer a proprietary interest were not subject to taxation as compensation at the time of exercise. The court emphasized that it must assess the "motives" behind the granting of an option.[126] In Geeseman's case, since the taxpayer had no obligation to continue employment, the court classified the option as non-compensatory, allowing for the taxpayer to avoid taxation on the exercise of the option (with capital gain when the stock was ultimately sold). The IRS amended regulations to clarify that an employee had gross income only to the extent the spread between option price and FMV was in the "nature of compensation."[127] Proprietary options were taxed at sale of stock. Compensatory options were taxed on exercise.[128]

However, the distinction between proprietary and compensatory stock options was rejected by the Supreme Court in *Commissioner v. Smith*. There, Smith received an option to purchase stock with an exercise price equal to the fair market value of the stock at grant. When the stock rose in value and Smith exercised, the IRS argued that the spread was taxable income. The Court ruled that the taxable event occurred at exercise, not at grant. The Court emphasized that if an option had no market value at grant, any benefit must logically arise at exercise, when value is realized.[129] So, compensation received through options was deemed ordinary income, not capital gain. As a result, the IRS revised its regulations to eliminate the proprietary option doctrine and standardize taxation at exercise.[130]

Following the *Smith* decision, Congress stepped in and renewed the bifurcated treatment of stock options. Instead of bifurcating based on whether the

---

[124] *See* Jack D. Edwards, *Executive Compensation: The Taxation of Stock Options*, 13 VAND. L. REV. 475, 476 (1960).

[125] Geeseman v. Comm'r, 38 B.T.A. 258 (1938).

[126] *Id.* at 264. Again, we observe the pivot towards primary motive tests. *See* discussion *supra* Section II.A.1.

[127] Richard J. Horwich, *A Tale of Two Dicta: The Non-Restricted Stock Option*, 18 U. MIA. L. REV. 596, 597-98 (1964).

[128] *Id.* at 598.

[129] Comm'r v. Smith, 324 U.S. 177, 177-82 (1945).

[130] *See* Horwich, *supra* note 127, at 597-98.

options were compensatory or proprietary, options were bifurcated based on whether they were qualified or non-qualified. Qualified stock options were required to meet a series of statutory requirements. Employees were not taxed on the grant or exercise of the qualified stock option. Instead, they were taxed on capital gain when the stock was ultimately sold. This offered a path to tax-favored treatment, but only for qualified plans. The goal was to encourage long-term equity ownership and avoid abuse by limiting tax advantages to true incentive plans.[131]

Non-qualified options remained taxable as ordinary income on exercise of the option. Despite the benefits of § 421, non-qualified stock options (NQSOs) remained widely used and taxpayers continued to search for ways to justify capital gains treatment for NQSOs. This effort hinged on two Supreme Court dicta, one from *Smith*, the other from *LoBue.*[132]

Though *Smith* upheld taxation at exercise, the Court noted: "It of course does not follow that in other circumstances not here present the option itself . . . could not be found to be the only intended compensation."[133] Taxpayers used this sentence to argue that if an option had ascertainable value at grant, and if that value reflected the full intended compensation, then all tax should be imposed at grant, and any later appreciation should be capital gain.

A variety of different approaches resulted. In *McNamara v. Commissioner*, the court only taxed the spread at grant, ignoring appreciation at exercise.[134] This treated the grant as the only compensation. In *Bowen*[135] and *Rosenberg*,[136] courts ruled that no income was recognized, even with substantial spreads, based on subjective motives. Courts in *Sorenson*,[137] *Kane*,[138] and *Babbit*,[139] applied *Smith* to treat the spread at exercise as compensation, particularly where options were part of negotiations or employment incentives. In *Kuchman*,[140] the court ruled that valuation was impossible, so no tax was due at exercise. The court did not determine if or when tax would be due. Finally, in *Lehman*,[141] the court rejected the IRS argument that lapse of restrictions is a taxable event and allowed deferral of taxation

---

[131] The current incentive stock option requirements include: (1) the employee must not dispose of the share within two years of the grant of the option or within one year of the exercise of the option, (2) the options must be exercised only while the individual is an employee or within 3 months of separation, (3) the strike price of the option must not be lower than the fair market value of the stock, and (4) the option must be non-transferrable except upon death. I.R.C. § 422(a)–(b). These requirements have changed over the years. Previously it was possible for incentive stock options to be in-the-money at grant so long as the strike price was at least 85% of fair market value. Edwards, *supra* note 124, at 479-80.

[132] Comm'r v. LoBue, 351 U.S. 243, 247 (1956) ("When assets are transferred by an employer to an employee to secure better services, they are plainly compensation.").

[133] *Smith*, 324 U.S. at 182.

[134] Macnamara v. Comm'r, 210 F.2d 505, 508-09 (7th Cir. 1954).

[135] Bowen v. Comm'r, 13 T.C.M. (CCH) 668, 668 (1954).

[136] Rosenberg v. Comm'r, 20 T.C. 5, 10 (1953).

[137] Sorenson v. Comm'r, 22 T.C. 321, 341-42 (1954).

[138] Kane v. Comm'r, 25 T.C. 1112, 1126 (1956).

[139] Babbit v. Comm'r, 23 T.C. 850, 864-65 (1955).

[140] Kuchman v. Comm'r, 18 T.C. 154, 163 (1952).

[141] Lehman v. Comm'r, 17 T.C. 652, 653-54 (1951).

until sale at capital gains rates. In combination, *Kuchman* and *Lehman* opened a path for total deferral and conversion to capital gains, enabling sophisticated avoidance strategies.[142]

The Supreme Court re-engaged in *LoBue*,[143] reaffirming the holding in *Smith* that stock options were compensation and again rejecting the proprietary/compensatory distinction. "When assets are transferred by an employer to an employee to secure better services they are plainly compensation."[144] The Court held intent was irrelevant and only substance governs. In dicta, however, the Court nodded to *McNamara* and noted that if an option has market value and is freely transferable, it might be taxable at grant, and appreciation thereafter would be capital gain.[145]

C. Current Law

There are currently three different approaches to taxing compensatory options, but only two of them are practically relevant.

If the option meets the stringent requirements for qualified stock options, then there are no tax consequences to the grant or exercise of the option. Any income from the sale of the stock is taxed as capital gain.

If the option is non-qualified, there are two potential treatments, although only one is practically relevant. The Code and Regulations (in a nod to *LoBue*) acknowledge the possibility of an option with readily ascertainable value.[146] If an option were to have a readily-ascertainable value, that value would be taxed at grant (rather than exercise), and any subsequent income from the sale of stock would be capital gain.[147] However, the regulation's stringent definition of "readily ascertainable" ensures that no real world options are taxed in this way. In order for the value of an option to be "readily ascertainable", the regulations require either that the option be "actively traded on an established market" or that an option be (i) transferable by the optionee, (ii) exercisable in full by the optionee, (iii) not subject to any conditions which have a significant effect up on the value of the option, and (iv) the value must be readily ascertainable after considering whether the underlying property can be valued, the probability that the underlying property will increase or decrease, and the duration of the option.[148] In the real world, compensatory options are not traded on established markets and they are always

[142] Edwards, *supra* note 125, at 483-84.
[143] Comm'r v. LoBue, 351 U.S. 243, 247 (1956).
[144] *Id.*
[145] *See id.* at 248–49, 249 n.8.
[146] *See* I.R.C. § 83(e)(4); Treas. Reg. § 1.83-7(a).
[147] I.R.C. § 83(e)(3). Section 83(e) excludes specific types of employee compensation that Congress has deemed not-currently-taxable. This includes incentive stock options, contributions to retirement plans, and group-term life insurance.
[148] Treas. Reg. § 1.83-7(b).

subject to conditions and restrictions (including vesting and non-transferability) that affect their value. This definition is virtually impossible to satisfy.[149]

Almost all non-qualified stock options are taxed instead at exercise or on vesting, whichever is later. Section 83 addresses property received for services, including compensatory options. The general rule is that the fair market value of the property (less any amount paid for the property) is included in income.[150] Thus, for non-qualified options, the spread between the value of the stock and the exercise price is generally included in income at exercise.

TABLE 2: TAX TREATMENT OF OPTIONS

	At Grant	**At Exercise**	**Sale of Stock**
Qualified Stock Option	No tax consequence	No tax consequence	Capital Gain based on spread between exercise price of option and sale price of stock
Non-Qualified Stock Option with a Readily Ascertainable FMV (rare)	Value of option taxed as ordinary income	No tax consequence	Capital gain based on spread sale price of stock and the sum of the value of option and its exercise price
Non-Qualified Stock Option without a Readily Ascertainable FMV	No tax consequence	Spread between value of stock and exercise price taxed as ordinary income	Capital gain on post-exercise increase in stock value

One last possibility deserves mention—Section 83 waits to tax taxpayer until the property is no longer subject to a “substantial risk of forfeiture.”[151] If the vesting occurs prior to exercise, then the option is taxed at exercise as described above. However, if the vesting occurs after exercise (i.e., the stock can still be forfeited by the employee if she leaves employment), then Section 83 waits to tax her when the stock vests. In that situation, the taxpayer can still elect to be taxed on the spread at exercise despite the risk of forfeiture.[152]

---

[149] *See* Cramer v. Comm’r, 64 F.3d 1406, 1412-14 (9th Cir. 1995) (holding that Treas. Reg. § 1.83-7 was a reasonable interpretation of options with a “readily ascertainable fair market value”).

[150] I.R.C. § 83(a).

[151] I.R.C. § 83(a), (c)(1)-(2).

[152] I.R.C. § 83(b).

D. Floors in Option Taxation

We have seen that floors can be a powerful tool for improving the taxation of situations in which taxpayer heterogeneity hinders accurate measurement of income. In this part, we consider three ways in which floors might be incorporated in the taxation of options.

1. In-the-Money Vested Options at Grant

Let's start with a somewhat unrealistic but simple example to build the intuition. Imagine that Sharon receives an option to purchase Employer Co. stock at $600. She is permitted to exercise the option at any time in the next two years. The option is not subject to a vesting requirement but is non-transferrable. At the time when the option is granted, Employer Co. stock is trading at $550. This option is "in-the-money," if she exercised the stock and immediately sold the stock, she would have income of $50.

Under current law, this option would not be taxed at grant. Assuming that these options are not publicly traded, the option likely does not have a readily ascertainable fair market value. For a non-publicly traded option to have readily ascertainable fair market value, it must be transferrable.[153] Thus, Sharon controls the timing of her income. When she exercises the option, she will recognize ordinary income equal to the spread between the exercise price of $550 and the stock price at exercise.

The floor approach would simply require taxpayers to include the amount that their (vested) options are in-the-money at the time that the option granted.[154] This amount is called the option's "intrinsic value." The value of the option also includes its "time value," the privilege to exercise the option later when the value of the stock is perhaps even higher.[155] The intrinsic value of an option is simple to calculate, mere subtraction. The time value of an option is much more complicated

[153] Treas. Reg. § 1.83-7(b)(2)(ii).

[154] Others have proposed versions of a floor solution for the specific problem of option taxation. Before the current version of Section 83, the 7th Circuit held that an employee was taxable on the intrinsic value of an option at the time of grant. *McNamara*, 210 F.2d at 508-09; *see* Edwards, *supra* note 125, at 481 ("Just because the option was intended to be compensation in the year it was granted does not mean that the spread at that time determines the amount of gain."); Davide Proietti, *Avoiding Tax Avoidance: A Rational Approach to Close Existing Loopholes in the U.S. Corporate Tax System*, 12 F.I.U. L. REV. 225, 247-54 (2016) (proposing to tax stock options based on their intrinsic value when issued and then a subsequent adjustment at exercise, including additional income if the value of the stock went up or a deduction if the value of the stock went down). This was the approach taken by the Treasury Regulations before Congress enacted Section 83. *See* Treas. Reg. § 1.421-6 (1959); T.D. 6416 (taxing employee on the spread between market value and exercise price when the option vests); Edwards, *supra* note 125, at 495.

[155] Treas. Reg. § 1.83-7(b)(3) ("Therefore, the fair market value of an option is not merely the difference that may exist at a particular time between the option's exercise price and the value of the property subject to the option, but also includes the value of the option privilege for the remainder of the exercise period.") The extent to which an option is currently in the money is a floor on the value of the option. An out-of-the-money or underwater option will have no intrinsic value but can still have time value.

(even for a relatively simple option without vesting requirements) and involves options about the risk-free rate of return and the volatility of stock.

The floor approach avoids these valuation issues and prevents inappropriate deferral of income by a taxpayer that simply defers the exercise of in-the-money, vested options. Under this approach, the taxpayer would take an additional basis in the option equal to the amount of income included. Once exercised, the taxpayer would have a basis in the stock equal to the previously included income and the exercise price paid for the stock.

This is an unrealistic example for a few reasons. First, most compensatory options are subject to vesting requirements. Second, employers are unlikely to compensate employees using in-the-money options because of two tax rules that make them very unattractive. Enacted in 1986, Section 162(m) imposes a $1 million cap on deductible executive pay for publicly traded companies.[156] However, non-discounted options (those with an exercise price at or greater than the stock price at time of grant) are exempted from the cap under § 162(m) whereas discounted or other non-performance pay triggers the deduction caps. The deduction cap encourages public companies to issue at-the-money or out-of-the money stock options for compensation.[157]

Section 409A was enacted in 2004 as part of the American Jobs Creation Act of 2004 and effectively eliminated the use of in-the-money options to defer income. Section 409A imposes heavy penalties if a NQSO's exercise price if set below fair market value.[158] Options that are in-the-money at grant are treated as deferred compensation,[159] with immediate taxation and a 20% penalty.[160]

2. *Option With Readily Ascertainable Value Prior to Exercise*

Consider a more realistic example. Sharon is granted an at-the-money option to purchase Employer Co. stock at $600. The option is non-transferrable and is subject to a two-year vesting requirement. She can exercise the option any time after the two-year vesting period. Sharon works the required two years and satisfies the condition. At the time the option vests, Employer Co. stock is trading at $750. She holds onto the option for three more years and exercises when the stock is worth $1000. She immediately sells the stock for $1000.

The Treasury Regulations provide that the determination of whether an option has "readily ascertainable value" is at the grant of the option, and it does not matter whether a readily ascertainable value can be determined at some later date.[161]

---

[156] I.R.C. § 162(m).

[157] Gregg D. Polsky, *Controlling Executive Compensation Through the Tax Code*, 64 WASH. & LEE L. REV. 877, 896-99 (2007); Brian J. Hall & Kevin J. Murphy, *The Trouble with Stock Options*, 17 J. ECON. PERSP. 3, 8 and 22-27 (2003).

[158] *See* I.R.C. § 409A; David I. Walker, *The Non-Option: Understanding the Dearth of Discounted Employee Stock Options*, 89 B.U. L. REV. 1505, 1525-26 (2009).

[159] *See* Treas. Reg. § 1.409A-1(b)(5).

[160] I.R.C. § 409A(a)(1)(A)-(B).

[161] Treas. Reg. § 1.83-7(a) ("If section 83(a) does not apply to the grant of such an option because the option does not have a readily ascertainable fair market value at the time of grant,

This would generally happen because the vesting requirements of an option have lapsed. Once the option has vested, there is no substantial risk of forfeiture.[162]

The example of a vested options raises two related problems—when to tax and how much to include. On the first question, the choice is between at grant, on vesting, or on exercise. The regulations are sensible in skipping the grant—options that may be forfeited are difficult to value.[163] Standard option valuation techniques are useless. But why not at vesting? It seems sensible to tax options once we are sure that (some) income has been earned. By waiting until exercise, the tax law allows employees to achieve indefinite deferral of income.

If we assume that vesting is an appropriate time for taxing, how much income should be included for options that vest (but are not immediately exercised)? Here we run into a more technical challenge. Some vested compensatory options may be close enough to publicly traded options to infer a value, but the options markets are much thinner than the stock markets even for S&P 100 companies. It will often be impossible to find publicly traded options that are identical or even close to vested compensatory options. Option pricing theory provides another approach, but for a tax system that relies on self-reporting, it may be inadministrable to require taxpayers to use the Black-Scholes pricing formula to determine their taxable income.[164]

An alternative would be to employ a floor. This approach would require taxpayers to include in income the amount of the intrinsic value of the options at the time that the option vests. This approach addresses valuation concerns and prevents taxpayers from improperly deferring income by merely postponing the exercise of their in-the-money, vested options. In this method, the taxpayer would receive an additional basis in the option that matches the income recognized. Upon exercising the option, the taxpayer's basis in the stock would be the sum of the previously recognized income and the exercise price paid for the shares.

Returning to our example, Sharon is not taxed when she receives an at-the-money stock option at $600. Under current law, Sharon is not taxed when the option vests in year two. She is not taxed even though she keeps the option, even if she leaves her job and the option can be exercised for an immediate profit. The vested option clearly meets the definition of income under *Glenshaw Glass*—it is an accession to wealth, clearly realized, over which the taxpayer has complete

---

sections 83(a) and 83(b) shall apply at the time the option is exercised or otherwise disposed of, even though the fair market value of such option may have become readily ascertainable before such time.").

[162] According to Treasury Regulations, an option must be (1) transferrable, (2) exercisable, *and* (3) not subject to a vesting condition to have a readily ascertainable fair market value. Treas. Reg. § 1.83-7(b)(2). Thus, a vested option that is immediately exercisable would still not meet the "readily ascertainable fair market value" bar if the option or stock was non-transferrable.

[163] Even applying a floor approach at the time of grant would lead to zero inclusion. Some compensatory options will be forfeited.

[164] The most difficult part of applying the option price formula is (1) figuring out the underlying asset's volatility, i.e., how much the value of the underlying asset fluctuates over time and (2) the appropriate discount rate.

dominion. Sharon defers recognizing this income until year five when she exercises the option.[165]

With the floor approach, Sharon would instead have $150 of income in year two when the option vests.[166] Sharon would take a $150 dollar basis in the option. In year five, when Sharon exercises the option, there are two possible tax approaches. The first approach would mirror current law. Sharon would have additional ordinary income of $250, and her employer would have a matching deduction at that time. This would replicate current law. The only difference would be that a portion of the income would have been accelerated to the year when the option vests. This seems more consistent with the concept of a floor. We are not taxing Sharon on the fair market value of the option. We are simply including a minimum amount and then waiting to reconcile the result when she ultimately does exercise the option. Sharon would have a $1000 basis in the stock. When she sells the stock for $1000, she recognizes no capital gain or loss.

The second approach would treat the exercise of the option as a nontaxable event. Sharon would instead have a $750 basis in the stock ($150 inherited basis from the option plus the $600 exercise price). When she sells the stock, she recognizes $250 of capital gain. This seems like the appropriate treatment if we taxed Sharon on the fair market value of the option when it vested. However, it allows Sharon to convert some amount of income (the time value of the option) from ordinary to capital gain.

TABLE 3: TAX TREATMENT OF STOCK OPTIONS

	Option Granted (year 0)	**Option Vests** (year 2)	**Option Exercised** (year 5)	**Stock Sold** (year 5)
Current Law	Not taxed	Not taxed	$400 of ordinary income	No capital gain
Floor Approach 1	Not taxed	$150 of ordinary income	$250 of ordinary income	No capital gain
Floor Approach 2	Not taxed	$150 of ordinary income	Not taxed	$250 of capital gain

But what happens if the stock loses value? Take the same example, but assume that the stock drops in value and Sharon ultimately exercises the option when the stock price is only $650. She would then have included too much income at vesting. She would be allowed a tax loss of $100. Given that the inclusion at

[165] On exercise, she recognizes $400 of ordinary income. Under Section 83(h), the employer receives a matching deduction at that time.

[166] Her employer would get a matching deduction of $150. *See* I.R.C. § 83(h).

vesting was ordinary income, it seems better to treat the subsequent loss as ordinary as well.

3. *Section 83(b) and the Floor Approach*

When a service provider receives property subject to a vesting requirement, Section 83(b) allows an election for the taxpayer to include income currently using the fair market value of the property as if were not subject to any risk of forfeiture. The upshot of making an 83(b) election is that any subsequent increase in the value of the property is taxed as capital gain. The downside is that if the taxpayer fails to meet the vesting requirement (and forfeits the property), they are limited to a capital loss.

Because of Section 83(e)(3), the recipient of a non-vested option cannot make a Section 83(b) election.[167] This has always had a dubious circular logic. The substantial risk of forfeiture is what prevents the option from having a readily ascertainable fair market value. But if the taxpayer is willing to accept a valuation assuming away the risk of forfeiture, why should they not be able to include that larger amount in income at option grant? The circularity betrays a fundamental discomfort with option valuation, regardless of whether there are vesting requirements or not.[168]

Can we combine Section 83(b) with a floor? For example, what if Section 83(b) allowed the recipients of nonvested options to elect to include income equal to the option's intrinsic value at the time of grant? Returning to the previous example, the employee could make an 83(b) election on the grant of the nonvested stock option and include $0 of income. Any subsequent increase or decrease in the value of the stock would be capital gain or loss. Since most options are granted at-the-money or out-of-the money, these options have no intrinsic value, the Section 83(b) election would be costless. There would be no income included at grant.[169] All subsequent income from the option would be capital gain.

This would seem inappropriately taxpayer favorable. There is clearly a compensatory component when options are received for services. The ordinary income/capital gain distinction is muddy, but it seems that treating all the income

---

[167] Section 83(e)(3) makes Section 83 (and by implication 83(b)) inapplicable to options without a readily ascertainable fair market value. I.R.C. § 83(e)(3).

[168] Given this discomfort, it is interesting to speculate on how the IRS would treat a grant of vested stock options to an employee. Those options would have readily ascertainable fair market value either if they were publicly traded or if the value of the option could "be measured with reasonable accuracy," taking into account the property value, the length of the option, and the probability that the underlying property value will increase or decrease. Treas. Reg. § 1.83-7(b)(3). The list of factors is a subset of the inputs to the Black-Scholes option formula (the option formula also includes a time-value-of-money discount rate). Would the IRS accept the use of Black-Scholes for vested compensatory stock options?

[169] The risk with Section 83(b) elections is the asymmetrical tax treatment if the option is later forfeited. The taxpayer will have ordinary income on the Section 83(b) election but a later capital loss. Treas. Reg. § 1.83-2(a). The taxpayer loses both on character (ordinary income vs capital loss) and on timing (earlier income, later deduction). These risks disappear if the Section 83(b) election results in no income inclusion.

from an option as capital gain is too taxpayer favorable. If the Section 83(b) "floor" election were available, almost all taxpayers would exercise the election and effectively all income from options would be converted to capital gain.

However, Section 83(h) requires that the deduction of the employer match the timing and amount of the income included by the employee.[170]

TABLE 4: SECTION 83(B) TREATMENT OF STOCK OPTIONS

	Option Granted (year 0)	**Option Vests** (year 2)	**Option Exercised** (year 5)	**Stock Sold** (year 5)
Current Law	Not taxed	Not taxed	$400 of ordinary income	$0 of capital gain
83(b) Current Law	Not available	—	—	—
83(b) Floor Approach	$0 of income	Not taxed	Not taxed	$400 of capital gain

CONCLUSION

A persistent problem in taxation is that taxpayer heterogeneity makes measuring income difficult. This Article has showed just how pervasive this problem is: loans to employees, seller-financed sales of real property, every fringe benefit, and compensatory stock options. The common thread is that there are reasons to suspect that there is some personal benefit from the transaction—a lower interest rate, an employee discount, or an unvested option—that is hard to value because it depends so much on the characteristics and preferences of the taxpayer. This is a serious tax policy challenge.

This Article has explored one approach to mitigate taxpayer heterogeneity. Floors allow us to include some amount of benefit in income when the actual benefit will vary dramatically between taxpayers. When well designed, a floor improves the accuracy of measuring income, simplifies tax administration, and will generally raise revenue. This paper has also shown that floors are already sprinkled throughout the tax law (albeit in a haphazard way). Qualified employee discounts, imputing hidden interest in loans, and requiring Alphabet employees to pay a minimum amount for their cafeteria food. The first suggestion of this Article is that floors should be considered more broadly as a default approach to taxpayer heterogeneity. The second suggestion is that existing floors should be evaluated for their effectiveness as floors. Is the rate at which the federal government borrows the appropriate floor for measuring hidden compensation when a professor borrows money from his university? Perhaps not.

[170] *Cf.* Alvin C. Warren Jr., *Taxation of Options on the Issuer's Stock*, 82 TAXES 47, 48 (2004) (showing that deductibility under 83(h) effectively allows issuing employers to recognize gain or loss on their own stock, in tension with Section 1032).